Comptroller of the Currency
Administrator of National Banks

# Quarterly Journal

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## Background

The Office of the Comptroller of the Currency (OCC) was established in 1863 as a bureau of the Department of the Treasury. The OCC is headed by the Comptroller who is appointed by the President, with the advice and consent of the Senate, for a 5-year term.

The OCC regulates national banks by its power to:

- Examine the banks;
- Approve or deny applications for new charters, branches, capital or other changes in corporate or banking structure;
- Take supervisory actions against banks that do not conform to laws and regulations or which otherwise engage in unsound banking practices, including removal of officers, negotiation of agreements to change existing banking practices, and issuance of cease and desist orders; and
- Issue rules and regulations concerning banking practices and governing bank lending and investment practices and corporate structure.

The OCC divides the United States into six geographical districts, with each headed by a Deputy Comptroller.

The Office is funded through assessments on the assets of national banks, and federal branches and agencies. Under the International Banking Act of 1978, the OCC regulates federal branches and agencies of foreign banks in the United States.

## The Comptroller

Eugene A. Ludwig took the oath of office on April 5, 1993, as the 27th Comptroller of the Currency.

By statute, the Comptroller serves a concurrent term as Director of the Federal Deposit Insurance Corporation and the Neighborhood Reinvestment Corporation. The Comptroller also serves as a member of the Federal Financial Institutions Examination Council.

Mr. Ludwig joined the OCC from the law firm of Covington and Burling in Washington, D.C., where he was a partner beginning in 1981. He specialized in intellectual property law, banking, and international trade. He has written numerous articles on banking and finance for scholarly journals and trade publications, and served as a guest lecturer at Yale and Harvard Law Schools and Georgetown University's International Law Institute.

Mr. Ludwig grew up in York, Pennsylvania, where he attended York Suburban High School. He earned a B.A. magna cum laude from Haverford College in Pennsylvania. He received a Keasbey scholarship to attend Oxford University, where he studied politics, philosophy, and economics and earned a B.A. and M.A. He holds an LL.B. from Yale University, where he served as editor of the Yale Law Journal and chairman of Yale Legislative Services.


The *Quarterly Journal* is the journal of record for the most significant actions and policies of the Office of the Comptroller of the Currency. It is published four times a year in March, June, September and December. The *Quarterly Journal* includes policy statements, decisions on banking structure, selected speeches and testimony, material released in the interpretive letters series, statistical data and other information of interest to the administration of national banks. Suggestions, comments or questions on content may be sent to Claire Emory, Senior Writer/Editor, Communications Division, Comptroller of the Currency, Washington, D.C. 20219. Subscriptions are available for $100 a year by writing to Publications—QJ, Comptroller of the Currency, P.O. Box 70004, Chicago, IL 60673-0004.

# Quarterly Journal

## Office of the Comptroller of the Currency

Eugene A. Ludwig

Comptroller of the Currency

The Administrator of National Banks

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# Operations of National Banks

## Overview

In the third quarter of 1996, national banks continued to dwindle in number, yet reported near-record earnings and continued asset growth. By year-end 1996, the number of national banks will likely drop to roughly 2,700 from nearly 5,000 a decade ago. Despite the decline in the number of national banks over the decade, national bank assets grew 52 percent during this period. For the last four years, national banks have reported record or near-record earnings. The sector's 1996 net earnings will exceed $30 billion.

The national banking sector is one in which 19 of 20 banks are profitable. The aggregate financial ratios — credit quality ratios, capital ratios, and performance ratios — indicate steady financial growth and general improvement. As macroeconomic conditions continued to improve in 1996, credit quality ratios improved across the board: loss reserves to noncurrent loans improved, noncurrent loans to total loans declined, and the ratio of OREO to OREO and RE loans dropped. Capital ratios also improved, as the equity-to-asset ratio and the leverage ratio increased, the risk-based capital ratio remained virtually unchanged, and noncurrent loans to equity dropped. Performance ratios indicated a slightly lower return on equity relative to the third quarter 1995 and a slight increase in net loan loss provisions to loans, but were otherwise stable.

The only surprise in the aggregate statistics during the last year appeared to be the dramatic growth in domestic deposits — more than $120 billion. This increase occurs after four years of little or no growth. The growth in domestic deposits also coincided with the first reduction in purchased liabilities in the last five years. In a decade of rapid transition, many changes, and new products and technologies, banks appeared to return to the traditional role of banks, if only momentarily, acting primarily as lenders and deposit receivers. Banks increased their loans by roughly $90 billion over the past year. Judging by their returns, national banks have prudently shifted their portfolios toward real estate loans, commercial and industrial loans, and consumer loans and away from investment securities as their risk/return tradeoff deteriorated in the securities markets.

Consistent with the spirit of the Federal Deposit Insurance Corporation Improvement Act (FDICIA), in 1996 national banks grew their assets while demonstrating their ability to raise equity capital. National banks increased their overall equity capital in the past year by $20 billion to an historic high — $206 billion. The overall index of national bank equity capital to assets increased from 7.9 percent to 8.3 percent, the highest ratio in the last several decades. Equity asset ratios have been important explanatory variables in assessing the risks associated with bank failure.[1] In almost all studies on bank failure, increases in equity asset ratios decrease the likelihood of a bank's becoming a troubled institution.

Two questions dominate any discussion of the condition of the national banking industry in 1996:

- Will the national banking sector continue to consolidate?
- Can the national banking sector sustain recent earnings growth?

## Answering The Questions

The first question appears easy to answer but difficult to quantify. Over the last decade the number of national banks declined by 45 percent, as national bank assets increased by 52 percent. The mean national bank grew 262 percent in asset size over the decade. Mergers, holding company roll-ups, and take-overs continued to reduce the number of national banks during 1996. As interstate banking becomes a reality in 1997, further consolidation appears inevitable.[2]

The second question is both difficult to answer and difficult to quantify. The remainder of this article will focus on this quantification.

## The Simple Answer to the Question of Whether Banks Can Sustain Earnings

Some may be tempted to reach for a simple answer to this question, by relying on suspect tools: incremental analysis and trend analysis. The growth of the national banking sector over the last few years has been suffi-

[1] "The Changing Business of Banking: A Study of Failed Banks from 1987 to 1992," A CBO Study. The Congressional Budget Office, Washington DC, June 1994

[2] Daniel Nolle, Tara Rice, and James Barth, "Commercial Bank Structure, Regulation, and Performance: An International Comparison." Presented at the Atlantic Economic Society in Washington, DC, October 9-12, 1996.

ciently "slow to moderate" and national bank returns sufficiently high to indicate that banks should be able to sustain returns, if the economic environment remains stable. This implies, of course, that national banks are not now taking excessive risks and that the economic environment will remain stable.

This simple answer suggests four more years of high earnings, modest asset growth, comparatively few bank failures, and continued high returns on equity and assets. The aggregate national bank returns on equity and assets have remained at or near 16 percent and 1.3 percent, respectively, since 1993, which compares favorably to the returns of most corporations in the S&P 500.

The simple analysis would point to favorable asset quality indicators. Asset quality in 1996 remained high; banks continued to decrease noncurrent real estate and C&I loans. Only noncurrent consumer loans increased during the last quarter and over the last year, which reflects in part a nationwide increase in consumer debt and bankruptcies during 1996. In addition to traditional loans, national banks now supply lines of credit that exceed $900 billion and support a thriving derivatives market, the notional value of which hovers in the $8 trillion range. With asset quality up and the economic environment stable, the simple analysis suggests good weather approaching.

## But Are Those Dark Clouds On the Horizon?

Although it appears that the industry is financially healthy and the simple answer "works," these trends by themselves do not resolve effectively whether banks can sustain current earnings. Reliance on trends in aggregate data provided a similar answer to banks in 1985. Using trend analysis and aggregate statistics, it appeared then that banks could sustain earnings.

At year-end 1985, national banks numbered 4,950, with one of five of these banks unprofitable. National banks held $1.6 trillion in assets, of which $28 billion was tied up in noncurrent loans and an additional $4 billion with OREO. Banks held $96 billion in Treasury securities.

On the liabilities side, total domestic deposits amounted to $1.2 trillion, $1 trillion of which was domestic deposits. Equity capital was $96 billion. The notional value of derivatives was $460 billion. National bank net income for 1985 was roughly $10 billion. The return on equity was a healthy 10 percent to 11 percent and the return on assets was 0.6 percent.

The general underlying economic and sectoral trends leading up to 1985 were positive. A few minor exceptions to these positive trends may have been: a few failures of small national banks in 1984, the resolution of Continental Illinois — a large national bank, and the rating of 285 national banks as problem banks in 1985. Continental could be considered an isolated case, and the problem banks represented only 6 percent of national banks. And because a large majority of the banks rated problem banks between 1934 and 1985 had survived, few analysts using the simple trend models would have suggested a high probability of a high failure rate for national banks or volatile national bank earnings.

As further consideration, the macro economy appeared to be growing well in 1985, the 1981 recession a vague memory. Economic growth appeared almost guaranteed. Banking, at year-end 1985, appeared to be in for a period of stable and sustainable earnings growth. Unfortunately, appearances were deceiving. With the benefit of perfect hindsight, we now know that OCC subsequently declared 1 out of every 10 of those 1985 national banks insolvent. Earnings for many national banks fell precipitously. The number of problem banks continued to grow. The country's economic growth was slow and sputtery, with rolling regional recessions, and the worst national recession (in terms of unemployment) of the post-World War II period loomed on the horizon.

Contrary to 1985 expectations, the OCC declared 405 national banks insolvent between 1986 and 1996. Many more banks rushed into mergers during this period to avoid resolution. Almost 1,800 national banks disappeared through failure or structural change. By year-end 1996 the number of national banks will be roughly 2,700, a 45-percent reduction from 1985.

The 1996 financial condition of national banks appears measurably better than the financial condition of the 1985 predecessors. As of the third quarter of 1996, only 1 of 20 national banks was unprofitable, and return on equity and return on assets were at historically high levels.

Table 1 suggests that the typical national bank in 1996 is financially stronger, better capitalized, and achieving a higher return on both its equity and assets than its 1985 counterpart. But could this be an illusion?

## What We Know Now That We Didn't Know in 1985

At year-end 1996, the OCC has 21 banks rated as problem banks (national banks with CAMEL ratings of 4 or 5), less than 1 percent of all national banks. This provides us some comfort that banks now seem less vulnerable than they did in 1985, but there is more. Autopsies of failed and survived banks over the decade provide some helpful generalizations

*Table 1. Comparison of 1985 and 1996 national bank aggregates*

| | Year-end 1985 | Third quarter 1996 |
|---|---|---|
| Number of banks | 4,950 | 2,736 |
| Unprofitable banks | 1 in 5 | 1 in 20 |
| Assets | $1.6 billion | $2.5 billion |
| Noncurrent loans | $27.8 billion | $17.8 billion |
| OREO | $3.9 billion | $3.0 billion |
| Total deposits | $1.2 billion | $1.8 billion |
| Domestic deposits | $1.0 billion | $1.5 billion |
| Derivatives | $.5 billion | $7.8 trillion |
| Net income | $9.9 billion | $30.1 billion |
| Equity capital | $96.2 billion | $206.3 billion |
| Return on equity | 10.7 percent | 15.9 percent |
| Return on assets | .6 percent | 15.9 percent |
| Number of problem banks | 285 | 21 |

The relative frequency of bank failures between 1985 and 1996 varied inversely with initial bank CAMEL ratings. For example, banks initially classified as CAMEL 1 in 1985 failed with a smaller relative frequency than banks classified as CAMEL 2, 3, 4, and 5. Similarly, banks classified as CAMEL 2 in 1985 failed with a smaller relative frequency than CAMEL 3s, CAMEL 4s, and CAMEL 5s. This process was basically order-preserving for 1985; banks with higher CAMELs failed with greater frequencies. The same process also appears for CAMEL-rated banks from 1986 to 1995. We can generally say that the chances for a bank of a given size failing increases with the deterioration in its CAMEL rating.

We also know that for a given CAMEL rating, the relative frequency of resolution drops for larger banks. This generalization can be supported by an appeal to data between 1985 and 1996. Larger banks, of a given CAMEL rating, failed less frequently than smaller banks.

As a logical construct, we can also say that the relative frequencies of banks failing from a given population of size and CAMEL ratings increased as we examined subsequent years. For example, the cumulative frequency of bank failures tended to increase over time. This means that for a given bank of a particular size and CAMEL rating, the chances of that bank failing in one year is less than its failing two, three, four, or five years later.

Inferential statistics reveal that in addition to size and CAMEL rating, subsequent economic and demographic changes also affect relative frequencies of failure. This should not be surprising; it is reasonable that banks beset by poor subsequent economic conditions tend to fail at higher rates than banks experiencing better economic conditions.

Fortunately the "problem" of the problem banks bottomed out by 1991. In a dramatic change of events, the period of 1991 to 1996 has been marked by far fewer failures and problem banks. What changed? Clearly, national banks benefited by the ensuing period of positive economic growth, but banks also appeared to increase their productivity and efficiency, lowering costs and raising earnings.[3] Bank managers appeared to learn from past mistakes, their own mistakes and the mistakes of those managing failed institutions. So too did bank supervisors learn from past mistakes, insisting on better business planning. Both numbers of bank failures and resolution losses dropped during the period 1992-1996. It is reasonable therefore to conclude that the likelihood of national bank failures over the next decade appears substantially less than the likelihood of failure faced by the 1985 population of national banks.

## How the Autopsies Were Performed

As an example of cohort analysis, we examined 15 cohorts of banks defined by size and CAMEL over this last decade. We examined the relative failure frequency of banks within each cohort and time period, and we then applied these relative frequencies to 1996 cohorts to develop a rough estimate of the likelihood of failure for each of these new cohorts over the next five years.

Table 2 provides information on the relative frequency of resolution for 15 bank cohorts over the period 1986 to 1996:3, where size = (S1,...S3), and CAMEL rating = (C1-3,C4-5):

[3]Robert DeYoung, Kenneth Spong, and Richard Sullivan, "Management, Ownership, and Productivity in Commercial Banks," presentation at meetings of the Financial Management Association, New Orleans, LA, October 9-12, 1996.

*Table 2. Cumulative frequencies of bank failures across cohorts and with respect to subsequent years (percent)*

| *Years after cohort formed* | *One year* | *Two years* | *Three years* | *Four years* | *Five years* |
|---|---|---|---|---|---|
| S1C1-3 | .0 | .1 | .3 | 1.2 | 1.7 |
| S1C4-5 | 7.9 | 11.3 | 23.7 | 32.8 | 45.0 |
| S2C1-3 | .0 | .2 | .7 | 1.1 | 3.3 |
| S2C4-5 | 38.6 | 60.6 | 73.8 | 79.3 | 94.9 |
| S3C1-3 | .0 | .1 | .2 | .4 | 1.0 |
| S3C4-5 | 1.0 | 24.5 | 50.1 | 55.2 | 67.1 |

S1 National banks with: assets <$100 million;
S2 National banks with: $100 million ≤ assets <$ 1 billion;
S3 National banks with: $1 billion ≤ assets;
C1-3 National banks with CAMEL ratings 1-3;
C4-5 National banks with CAMEL ratings 4 or 5.

From this data we are able to establish a weighted average of the relative frequencies of failure for national banks over the historical period to estimate the probabilities of failure adjusted for 1996 data to project the relative frequencies of bank failures for each of the 1996 cohorts.

Financial improvement and consolidation in the 1996 national bank sector shifts the distribution of banks toward bigger banks with higher CAMEL ratings. As a result, the probability of failures falls relative to the 1985 distribution. By multiplying the relative frequencies of failures by the 1996 national banks in each of these cohorts, the model projects national bank failures over the next few years. The overall relative frequency of failure for all banks in 1996 (assuming similar economic conditions and the improved overall financial condition of banks in the industry) is roughly 2 percent over the next half decade with a modest failure rate of roughly five national banks per year over the next three years and fewer than 56 bank failures over the next five years. (See Table 3.)

If, however, economic conditions deteriorate, the number of failures could easily increase. The sustainability of 1996 national bank earnings is conditional on the state of the economy during the period 1997-2001. Although an unanticipated economic downturn could disrupt earnings and increase failures, the 1996 national banks are well capitalized, unlike the 1985 national banks, and it would take a lengthy economic downturn to do much damage.

*Table 3. Projected national bank failures across cohorts: 1997-2001*

| | *1996 number** | *1997 projected failures* | *1998 projected failures* | *1999 projected failures* | *2000 projected failures* | *2001 projected failures* |
|---|---|---|---|---|---|---|
| S1C1-3 | 1,493 | 0 | 1 | 3 | 4 | 16 |
| S1C4-5 | 15 | 1 | 1 | 2 | 1 | 2 |
| S2C1-3 | 1,000 | 1 | 0 | 2 | 3 | 10 |
| S2C4-5 | 6 | 1 | 1 | 1 | 1 | 2 |
| S3C1-3 | 209 | 0 | 0 | 0 | 1 | 2 |
| S3C4-5 | 0 | 0 | 0 | 0 | 0 | 0 |
| Total | 2,713 | 3 | 3 | 8 | 10 | 32 |

**Number of national banks with designated CAMEL ratings as of 12/96.*

*Aggregate performance data for national banks*
(Data through third quarter of each year)

| | *1991* | *1992* | *1993* | *1994* | *1995* | *1996* |
|---|---|---|---|---|---|---|
| Industry Structure | | | | | | |
| Number of banks | 3,870 | 3,652 | 3,386 | 3,145 | 2,896 | 2,736 |
| Number of banks with losses | 545 | 282 | 181 | 109 | 83 | 113 |
| Number of failed/assisted banks | 35 | 18 | 21 | 3 | 1 | 2 |
| Income Statement ($ billions) | | | | | | |
| Year-to-Date: | | | | | | |
| Net income | 7.02 | 13.11 | 19.27 | 20.16 | 21.86 | 22.55 |
| Net interest income | 52.56 | 57.04 | 60.50 | 62.54 | 64.77 | 70.62 |
| Noninterest income | 26.59 | 29.90 | 33.77 | 34.12 | 37.65 | 40.78 |
| Noninterest expense | 54.78 | 57.80 | 62.01 | 61.97 | 64.40 | 69.26 |
| Loan loss provision | 15.45 | 12.15 | 7.04 | 4.22 | 4.36 | 7.00 |
| Gains on securities sales, net | 0.95 | 1.84 | 1.37 | 0.25 | 0.13 | 0.32 |
| Extraordinary income, net | 0.72 | 0.24 | 1.59 | -0.04 | -0.01 | 0.09 |
| Net loan loss | 15.43 | 11.73 | 7.32 | 4.35 | 4.20 | 7.24 |
| Third Quarter: | | | | | | |
| Net income | 1.69 | 4.68 | 6.93 | 7.12 | 8.41 | 8.01 |
| Net interest income | 18.28 | 20.09 | 20.81 | 21.64 | 22.66 | 25.21 |
| Noninterest income | 9.09 | 10.40 | 11.86 | 12.04 | 13.63 | 14.27 |
| Noninterest expense | 19.43 | 20.19 | 20.76 | 21.34 | 21.79 | 24.36 |
| Loan loss provision | 5.79 | 4.21 | 2.12 | 1.29 | 1.70 | 2.52 |
| Gains on securities sales, net | 0.44 | 0.79 | 0.54 | -0.21 | 0.04 | 0.06 |
| Extraordinary income, net | 0.09 | 0.07 | 0.03 | 0.00 | 0.00 | 0.00 |
| Net loan loss | 5.74 | 4.44 | 2.23 | 1.32 | 1.76 | 2.59 |
| Performance Ratios (%) | | | | | | |
| Year-to-Date: | | | | | | |
| Return on equity | 7.67 | 13.30 | 17.04 | 16.31 | 16.63 | 15.94 |
| Return on assets | 0.48 | 0.91 | 1.29 | 1.27 | 1.31 | 1.29 |
| Net interest margin | 3.57 | 3.95 | 4.04 | 3.95 | 3.88 | 4.05 |
| Loss provision to loans | 1.66 | 1.38 | 0.78 | 0.44 | 0.42 | 0.62 |
| Net loan loss to loans | 1.66 | 1.33 | 0.82 | 0.45 | 0.40 | 0.64 |
| Noncurrent loans to loans | 4.23 | 3.73 | 2.56 | 1.47 | 1.21 | 1.11 |
| Loss reserves to loans | 2.66 | 2.81 | 2.63 | 2.34 | 2.11 | 2.00 |
| Loss reserves to noncurrent loans | 62.90 | 75.26 | 102.90 | 159.93 | 174.54 | 180.89 |
| Loans to assets | 62.05 | 60.57 | 60.05 | 60.56 | 63.45 | 65.29 |
| Loans to deposits | 79.30 | 78.69 | 79.96 | 84.75 | 90.76 | 91.86 |
| Equity to assets | 6.30 | 7.13 | 7.80 | 7.81 | 8.03 | 8.34 |
| Estimated leverage ratio | 6.10 | 6.74 | 7.36 | 7.44 | 7.51 | 7.59 |
| Estimated risk-based capital ratio | 9.81 | 11.19 | 12.46 | 12.55 | 12.55 | 12.27 |

Note. 1996 data are preliminary. Performance ratios and third quarter income statement data are not adjusted for the impact of mergers. 0.00 indicates a gain/loss of less than $5 million.
Financial and Statistical Analysis (12/09/96)

*Aggregate condition data for national banks*
(Data through third quarter of each year)

| | *1991* | *1992* | *1993* | *1994* | *1995* | *1996* |
|---|---|---|---|---|---|---|
| **Balance Sheet ($ billions)** | | | | | | |
| Assets | 1,995.51 | 1,979.50 | 2,060.46 | 2,203.56 | 2,321.17 | 2,473.22 |
| Loans | 1,238.32 | 1,199.08 | 1,237.33 | 1,334.37 | 1,472.79 | 1,614.73 |
| Real estate (RE) | 502.52 | 500.09 | 512.53 | 547.70 | 596.40 | 641.09 |
| Commercial & industrial (C&I) | 356.73 | 333.05 | 338.64 | 361.30 | 393.96 | 423.55 |
| Consumer (cnsmr) | 232.52 | 227.57 | 241.20 | 276.52 | 306.94 | 352.42 |
| Noncurrent loans | 52.36 | 44.78 | 31.63 | 19.56 | 17.78 | 17.85 |
| Noncurrent RE loans | 28.03 | 25.04 | 18.71 | 11.66 | 9.45 | 8.51 |
| Noncurrent C&I loans | 17.17 | 13.33 | 7.89 | 4.06 | 4.17 | 4.16 |
| Noncurrent cnsmr loans | 3.36 | 3.27 | 3.09 | 2.87 | 3.51 | 4.53 |
| Other real estate owned | 17.11 | 18.68 | 13.05 | 7.58 | 4.48 | 3.00 |
| Securities not in trading account* | 344.21 | 394.98 | 430.59 | 428.87 | 391.86 | 383.43 |
| Total liabilities | 1,869.71 | 1,838.26 | 1,899.67 | 2,031.54 | 2,134.87 | 2,266.96 |
| Total deposits | 1,561.63 | 1,523.74 | 1,547.36 | 1,574.49 | 1,622.78 | 1,757.76 |
| Domestic deposits | 1,372.25 | 1,333.10 | 1,336.26 | 1,318.50 | 1,338.82 | 1,492.03 |
| Loan loss reserve | 32.93 | 33.70 | 32.55 | 31.28 | 31.03 | 32.28 |
| Equity capital | 125.81 | 141.23 | 160.79 | 172.02 | 186.30 | 206.25 |
| Total capital | 151.73 | 167.89 | 191.68 | 205.71 | 219.87 | 232.60 |
| **Balance Sheet Changes ($ billions)** | | | | | | |
| Year-to-Date Changes: | | | | | | |
| Assets | 8.04 | –5.76 | 53.68 | 101.53 | 63.52 | 69.73 |
| Loans | –40.27 | –32.19 | 42.26 | 63.70 | 88.36 | 89.83 |
| Noncurrent loans | 0.52 | –5.62 | –8.47 | –6.77 | –0.09 | 0.17 |
| Other real estate owned | 2.66 | 1.00 | –4.11 | –2.92 | –1.56 | –0.76 |
| Securities not in trading account* | 31.27 | 34.77 | 26.75 | –8.24 | –22.48 | –7.33 |
| Total liabilities | 2.46 | –19.77 | 37.95 | 94.50 | 50.21 | 53.45 |
| Total deposits | 3.07 | –49.50 | –4.33 | –2.58 | –7.22 | 61.94 |
| Loan loss reserve | –1.29 | –0.15 | –0.51 | –0.28 | –0.04 | 1.02 |
| Equity capital | 5.58 | 14.01 | 15.73 | 7.04 | 13.31 | 16.28 |
| Total capital | 4.62 | 14.34 | 18.22 | 10.53 | 10.61 | 11.95 |
| Third Quarter Changes: | | | | | | |
| Assets | 31.01 | 4.47 | 46.60 | 18.25 | 19.75 | –68.18 |
| Loans | –11.20 | –8.76 | 29.86 | 33.92 | 30.43 | –17.18 |
| Noncurrent loans | –2.37 | –2.39 | –2.93 | –1.75 | –0.21 | –0.14 |
| Other real estate owned | –0.37 | 0.23 | –1.83 | –0.83 | –0.22 | –0.43 |
| Securities not in trading account* | 15.16 | 13.44 | 9.71 | –11.16 | 0.10 | –16.52 |
| Total liabilities | 29.18 | 0.20 | 41.76 | 14.44 | 15.26 | –66.40 |
| Total deposits | 26.79 | –18.71 | 18.41 | 10.15 | 5.68 | –37.29 |
| Loan loss reserve | –0.17 | –0.36 | 0.04 | –0.02 | –0.06 | –0.42 |
| Equity capital | 1.84 | 4.27 | 4.84 | 3.80 | 4.48 | –1.78 |
| Total capital | 1.17 | 5.37 | 6.50 | 5.00 | 4.64 | –5.08 |

*Beginning in 1994, securities classified by banks as "held-to-maturity" are valued at their amortized cost, and securities classified as "available-for-sale" are valued at their current fair value.
Note: 1996 data are preliminary.
Financial and Statistical Analysis (12/09/96)

## *Aggregate performance data for national banks by size*
## (Data through third quarter of each year)

| | *Under $100M* | | *$100M-$1B* | | *$1B-$10B* | | *Over $10B* | | *Total* | |
|---|---|---|---|---|---|---|---|---|---|---|
| | *1995* | *1996* | *1995* | *1996* | *1995* | *1996* | *1995* | *1996* | *1995* | *1996* |
| Industry Structure | | | | | | | | | | |
| Number of banks | 1,626 | 1,495 | 1,058 | 1,031 | 169 | 165 | 43 | 45 | 2,896 | 2,736 |
| Number of banks with losses | 53 | 78 | 27 | 30 | 3 | 5 | 0 | 0 | 83 | 113 |
| Number of failed/assisted banks | 1 | 2 | 0 | 0 | 0 | 0 | 0 | 0 | 1 | 2 |
| Income Statement ($ billions) | | | | | | | | | | |
| Year-to-Date: | | | | | | | | | | |
| Net income | 0.75 | 0.67 | 2.55 | 2.48 | 5.97 | 5.47 | 12.59 | 13.93 | 21.86 | 22.55 |
| Net interest income | 2.55 | 2.32 | 8.80 | 8.39 | 18.38 | 18.33 | 35.03 | 41.58 | 64.77 | 70.62 |
| Noninterest income | 1.11 | 1.06 | 2.84 | 3.22 | 9.68 | 9.58 | 24.01 | 26.91 | 37.65 | 40.78 |
| Noninterest expense | 2.50 | 2.32 | 7.37 | 7.28 | 16.65 | 16.11 | 37.88 | 43.54 | 64.40 | 69.26 |
| Loan loss provision | 0.08 | 0.09 | 0.47 | 0.62 | 2.22 | 3.33 | 1.58 | 2.96 | 4.36 | 7.00 |
| Gains on securities sales, net | –0.01 | 0.00 | –0.01 | 0.02 | –0.06 | 0.05 | 0.21 | 0.25 | 0.13 | 0.32 |
| Extraordinary income, net | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.03 | –0.01 | 0.06 | –0.01 | 0.09 |
| Net loan loss | 0.06 | 0.06 | 0.40 | 0.57 | 1.79 | 2.98 | 1.96 | 3.63 | 4.20 | 7.24 |
| Third Quarter: | | | | | | | | | | |
| Net income | 0.27 | 0.23 | 0.89 | 0.82 | 2.00 | 1.89 | 5.24 | 5.07 | 8.41 | 8.01 |
| Net interest income | 0.86 | 0.80 | 3.02 | 2.90 | 6.34 | 6.43 | 12.44 | 15.08 | 22.66 | 25.21 |
| Noninterest income | 0.42 | 0.38 | 0.99 | 1.11 | 3.38 | 3.30 | 8.84 | 9.49 | 13.63 | 14.27 |
| Noninterest expense | 0.85 | 0.79 | 2.48 | 2.52 | 5.60 | 5.59 | 12.86 | 15.46 | 21.79 | 24.36 |
| Loan loss provision | 0.04 | 0.04 | 0.19 | 0.26 | 1.05 | 1.19 | 0.42 | 1.03 | 1.70 | 2.52 |
| Gains on securities sales, net | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.01 | 0.04 | 0.05 | 0.04 | 0.06 |
| Extraordinary income, net | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Net loan loss | 0.03 | 0.03 | 0.16 | 0.21 | 0.71 | 1.08 | 0.85 | 1.27 | 1.76 | 2.59 |
| Performance Ratios (%) | | | | | | | | | | |
| Year-to-Date: | | | | | | | | | | |
| Return on equity | 12.77 | 11.76 | 13.93 | 13.75 | 17.37 | 15.61 | 17.27 | 16.85 | 16.63 | 15.94 |
| Return on assets | 1.29 | 1.22 | 1.27 | 1.29 | 1.43 | 1.33 | 1.27 | 1.28 | 1.31 | 1.29 |
| Net interest margin | 4.39 | 4.23 | 4.37 | 4.34 | 4.41 | 4.46 | 3.53 | 3.84 | 3.88 | 4.05 |
| Loss provision to loans | 0.25 | 0.31 | 0.39 | 0.53 | 0.81 | 1.20 | 0.26 | 0.42 | 0.42 | 0.62 |
| Net loan loss to loans | 0.20 | 0.20 | 0.32 | 0.49 | 0.65 | 1.08 | 0.32 | 0.52 | 0.40 | 0.64 |
| Noncurrent loans to loans | 1.15 | 1.20 | 0.96 | 1.02 | 0.96 | 1.03 | 1.37 | 1.14 | 1.21 | 1.11 |
| Loss reserves to loans | 1.47 | 1.38 | 1.56 | 1.57 | 2.18 | 2.16 | 2.21 | 2.03 | 2.11 | 2.00 |
| Loss reserves to noncurrent loans | 127.76 | 115.23 | 161.31 | 153.28 | 227.01 | 209.39 | 162.22 | 177.85 | 174.54 | 180.89 |
| Loans to assets | 54.65 | 56.36 | 61.44 | 61.23 | 66.72 | 68.04 | 63.01 | 65.39 | 63.45 | 65.29 |
| Loans to deposits | 63.14 | 65.27 | 74.14 | 74.37 | 96.90 | 101.94 | 94.30 | 93.39 | 90.76 | 91.86 |
| Equity to assets | 10.34 | 10.32 | 9.36 | 9.37 | 8.51 | 8.73 | 7.43 | 7.93 | 8.03 | 8.34 |
| Estimated leverage ratio | 10.31 | 10.41 | 9.18 | 9.25 | 8.07 | 8.03 | 6.79 | 7.00 | 7.51 | 7.59 |
| Estimated risk-based capital ratio | 18.55 | 18.16 | 15.24 | 15.30 | 12.67 | 12.50 | 11.82 | 11.58 | 12.55 | 12.27 |

Note: 1996 data are preliminary. Performance ratios and third quarter income statement data are not adjusted for the impact of mergers. 0.00 indicates a gain/loss of less than $5 million. Numbers may not add to total due to rounding
Financial and Statistical Analysis (12/09/96)

*Aggregate condition data for national banks by size*
(Data through third quarter of each year)

| | *Under $100M* | | *$100M-$1B* | | *$1B-$10B* | | *Over $10B* | | *Total* | |
|---|---|---|---|---|---|---|---|---|---|---|
| | *1995* | *1996* | *1995* | *1996* | *1995* | *1996* | *1995* | *1996* | *1995* | *1996* |
| **Balance Sheet ($ billions)** | | | | | | | | | | |
| Assets | 79.13 | 73.99 | 277.92 | 264.68 | 573.31 | 570.22 | 1,390.82 | 1,564.32 | 2,321.17 | 2,473.22 |
| Loans | 43.25 | 41.70 | 170.74 | 162.06 | 382.51 | 388.00 | 876.29 | 1,022.98 | 1,472.79 | 1,614.73 |
| Real estate (RE) | 23.90 | 23.17 | 95.48 | 92.77 | 149.65 | 150.38 | 327.37 | 374.77 | 596.40 | 641.09 |
| Commercial & industrial (C&I) | 7.19 | 7.05 | 28.25 | 27.47 | 80.73 | 77.22 | 277.79 | 311.80 | 393.96 | 423.55 |
| Consumer (cnsmr) | 7.01 | 6.82 | 38.22 | 33.40 | 126.80 | 132.24 | 134.90 | 179.96 | 306.94 | 352.42 |
| Noncurrent loans | 0.50 | 0.50 | 1.65 | 1.66 | 3.67 | 4.00 | 11.96 | 11.69 | 17.78 | 17.85 |
| Noncurrent RE loans | 0.24 | 0.23 | 0.92 | 0.85 | 1.68 | 1.48 | 6.61 | 5.95 | 9.45 | 8.51 |
| Noncurrent C&I loans | 0.22 | 0.22 | 0.46 | 0.48 | 0.64 | 0.76 | 2.85 | 2.71 | 4.17 | 4.16 |
| Noncurrent cnsmr loans | 0.04 | 0.05 | 0.23 | 0.28 | 1.20 | 1.63 | 2.03 | 2.57 | 3.51 | 4.53 |
| Other real estate owned | 0.18 | 0.13 | 0.42 | 0.31 | 0.56 | 0.47 | 3.32 | 2.09 | 4.48 | 3.00 |
| Securities not in trading account* | 25.55 | 22.70 | 75.34 | 72.15 | 110.00 | 99.38 | 180.97 | 189.20 | 391.86 | 383.43 |
| Total liabilities | 70.94 | 66.36 | 251.91 | 239.87 | 524.55 | 520.44 | 1,287.47 | 1,440.30 | 2,134.87 | 2,266.96 |
| Total deposits | 68.49 | 63.89 | 230.30 | 217.92 | 394.74 | 380.61 | 929.25 | 1,095.34 | 1,622.78 | 1,757.76 |
| Domestic deposits | 68.49 | 63.89 | 229.86 | 217.44 | 385.23 | 371.69 | 655.23 | 839.01 | 1,338.82 | 1,492.03 |
| Loan loss reserve | 0.64 | 0.58 | 2.66 | 2.54 | 8.33 | 8.38 | 19.41 | 20.78 | 31.03 | 32.28 |
| Equity capital | 8.18 | 7.64 | 26.00 | 24.81 | 48.76 | 49.78 | 103.35 | 124.03 | 186.30 | 206.25 |
| Total capital | 8.58 | 8.06 | 27.18 | 25.96 | 53.66 | 52.73 | 130.45 | 145.84 | 219.87 | 232.60 |
| **Balance Sheet Changes ($ billions)** | | | | | | | | | | |
| **Year-to-Date Changes:** | | | | | | | | | | |
| Assets | −7.46 | −4.37 | −0.97 | −7.31 | −27.75 | −23.27 | 99.70 | 104.68 | 63.52 | 69.73 |
| Loans | −3.18 | −0.88 | 2.54 | −1.62 | 0.06 | −2.87 | 88.94 | 95.21 | 88.36 | 89.83 |
| Noncurrent loans | −0.03 | 0.03 | 0.04 | 0.09 | −0.18 | 0.22 | 0.07 | −0.17 | −0.09 | 0.17 |
| Other real estate owned | −0.05 | −0.02 | −0.10 | −0.05 | −0.27 | −0.08 | −1.14 | −0.61 | −1.56 | −0.76 |
| Securities not in trading account* | −3.89 | −1.93 | −3.78 | −1.38 | −17.70 | −8.72 | 2.88 | 4.71 | −22.48 | −7.33 |
| Total liabilities | −7.23 | −4.02 | −2.66 | −6.98 | −29.77 | −23.63 | 89.88 | 88.09 | 50.21 | 53.45 |
| Total deposits | −6.82 | −4.16 | −2.00 | −8.84 | −33.08 | −27.27 | 34.68 | 102.21 | −7.22 | 61.94 |
| Loan loss reserve | −0.09 | −0.03 | −0.09 | −0.02 | 0.01 | −0.13 | 0.13 | 1.21 | −0.04 | 1.02 |
| Equity capital | −0.22 | −0.35 | 1.69 | −0.33 | 2.03 | 0.37 | 9.82 | 16.59 | 13.31 | 16.28 |
| Total capital | −0.61 | −0.21 | 0.61 | 0.01 | 0.51 | −0.09 | 10.10 | 12.25 | 10.61 | 11.95 |
| **Third Quarter Changes:** | | | | | | | | | | |
| Assets | −2.24 | −1.30 | 5.67 | 2.93 | 12.53 | 17.86 | 3.78 | −87.67 | 19.75 | −68.18 |
| Loans | −1.30 | −0.42 | 3.60 | 3.28 | 15.91 | 22.05 | 12.23 | −42.09 | 30.43 | −17.18 |
| Noncurrent loans | −0.02 | −0.02 | 0.08 | 0.08 | 0.26 | 0.45 | −0.53 | −0.65 | −0.21 | −0.14 |
| Other real estate owned | −0.02 | −0.01 | −0.01 | −0.02 | −0.08 | −0.01 | −0.11 | −0.40 | −0.22 | −0.43 |
| Securities not in trading account* | −0.92 | −0.98 | 2.10 | −0.87 | −1.99 | −2.65 | 0.92 | −12.02 | 0.10 | −16.52 |
| Total liabilities | −2.09 | −1.27 | 5.10 | 2.56 | 10.42 | 16.65 | 1.84 | −84.33 | 15.26 | −66.40 |
| Total deposits | −2.11 | −1.43 | 4.43 | 1.73 | −5.75 | 4.27 | 9.11 | −41.86 | 5.68 | −37.29 |
| Loan loss reserve | −0.04 | −0.02 | −0.02 | 0.03 | 0.60 | 0.45 | -0.60 | −0.89 | −0.06 | −0.42 |
| Equity capital | −0.15 | −0.02 | 0.58 | 0.37 | 2.11 | 1.21 | 1.95 | −3.34 | 4.48 | −1.78 |
| Total capital | −0.18 | −0.08 | 0.47 | 0.28 | 2.31 | 1.76 | 2.05 | −7.04 | 4.64 | −5.08 |

*Beginning in 1994, securities classified by banks as "held-to-maturity" are valued at their amortized cost, and securities classified as "available-for-sale" are valued at their current fair value. Numbers may not add to total due to rounding.
Note: 1996 data are preliminary.
Financial and Statistical Analysis (12/09/96)

## *Aggregate performance data for national banks by region*
## (Data through third quarter of 1996)

| | *Northeast* | *Southeast* | *Central* | *Midwest* | *Southwest* | *West* | *Total* |
|---|---|---|---|---|---|---|---|
| **Industry Structure** | | | | | | | |
| Number of banks | 313 | 368 | 582 | 498 | 679 | 296 | 2,736 |
| Number of banks with losses | 11 | 19 | 15 | 20 | 24 | 24 | 113 |
| Number of failed/assisted banks | 1 | 0 | 0 | 0 | 1 | 0 | 2 |
| **Income Statement ($ billions)** | | | | | | | |
| Year-to-Date: | | | | | | | |
| Net income | 6.75 | 4.19 | 3.24 | 1.89 | 2.03 | 4.45 | 22.55 |
| Net interest income | 20.93 | 13.21 | 10.46 | 5.06 | 6.32 | 14.63 | 70.62 |
| Noninterest income | 14.31 | 6.19 | 4.45 | 4.01 | 3.28 | 8.54 | 40.78 |
| Noninterest expense | 22.24 | 11.97 | 9.10 | 5.42 | 6.20 | 14.31 | 69.26 |
| Loan loss provision | 2.47 | 1.10 | 0.97 | 0.76 | 0.31 | 1.40 | 7.00 |
| Gains on securities sales, net | 0.18 | 0.11 | 0.04 | 0.02 | -0.04 | 0.01 | 0.32 |
| Extraordinary income, net | 0.00 | 0.00 | 0.00 | 0.03 | 0.00 | 0.06 | 0.09 |
| Net loan loss | 2.60 | 0.99 | 0.89 | 0.68 | 0.29 | 1.79 | 7.24 |
| Third Quarter: | | | | | | | |
| Net income | 2.57 | 1.40 | 1.19 | 0.64 | 0.69 | 1.53 | 8.01 |
| Net interest income | 7.57 | 4.68 | 3.74 | 1.73 | 2.20 | 5.30 | 25.21 |
| Noninterest income | 5.01 | 2.11 | 1.57 | 1.33 | 1.15 | 3.09 | 14.27 |
| Noninterest expense | 7.78 | 4.19 | 3.17 | 1.80 | 2.20 | 5.24 | 24.36 |
| Loan loss provision | 0.77 | 0.47 | 0.37 | 0.27 | 0.11 | 0.52 | 2.52 |
| Gains on securities sales, net | 0.02 | 0.04 | 0.02 | 0.00 | -0.01 | 0.00 | 0.06 |
| Extraordinary income, net | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Net loan loss | 0.95 | 0.37 | 0.31 | 0.24 | 0.11 | 0.62 | 2.59 |
| **Performance Ratios (%)** | | | | | | | |
| Year-to-Date: | | | | | | | |
| Return on equity | 16.52 | 16.01 | 14.74 | 18.80 | 14.54 | 15.65 | 15.94 |
| Return on assets | 1.30 | 1.23 | 1.20 | 1.50 | 1.21 | 1.39 | 1.29 |
| Net interest margin | 4.04 | 3.89 | 3.87 | 4.03 | 3.76 | 4.57 | 4.05 |
| Loss provision to loans | 0.74 | 0.50 | 0.55 | 0.96 | 0.32 | 0.63 | 0.62 |
| Net loan loss to loans | 0.78 | 0.45 | 0.51 | 0.85 | 0.31 | 0.80 | 0.64 |
| Noncurrent loans to loans | 1.57 | 0.80 | 0.90 | 0.93 | 0.96 | 0.98 | 1.11 |
| Loss reserves to loans | 2.38 | 1.60 | 1.77 | 1.83 | 1.54 | 2.24 | 2.00 |
| Loss reserves to noncurrent loans | 151.20 | 199.84 | 197.03 | 195.54 | 161.15 | 227.99 | 180.89 |
| Loans to assets | 64.41 | 67.26 | 66.22 | 62.82 | 56.27 | 69.15 | 65.29 |
| Loans to deposits | 92.50 | 96.44 | 92.26 | 89.32 | 71.66 | 97.58 | 91.86 |
| Equity to assets | 7.96 | 7.85 | 8.31 | 8.11 | 8.59 | 9.43 | 8.34 |
| Estimated leverage ratio | 7.45 | 7.30 | 7.91 | 7.87 | 8.09 | 7.52 | 7.59 |
| Estimated risk-based capital ratio | 12.38 | 11.84 | 12.25 | 12.62 | 13.44 | 11.94 | 12.27 |

Note: 1996 data are preliminary. Performance ratios and third quarter income statement data are not adjusted for the impact of mergers. 0.00 indicates a gain/loss of less than $5 million. Numbers may not add to total due to rounding

Financial and Statistical Analysis (12/09/96)

## Aggregate condition data for national banks by region
## (Data through third quarter of 1996)

| | Northeast | Southeast | Central | Midwest | Southwest | West | Total |
|---|---|---|---|---|---|---|---|
| **Balance Sheet ($ billions)** | | | | | | | |
| Assets | 752.95 | 482.68 | 369.28 | 169.94 | 226.27 | 472.09 | 2,473.22 |
| Loans | 485.01 | 324.67 | 244.53 | 106.77 | 127.33 | 326.43 | 1,614.73 |
| Real estate (RE) | 158.98 | 163.20 | 99.33 | 37.38 | 53.83 | 128.36 | 641.09 |
| Commercial & industrial (C&I) | 140.93 | 72.16 | 65.81 | 26.62 | 38.87 | 79.15 | 423.55 |
| Consumer (cnsmr) | 114.97 | 56.58 | 57.01 | 31.56 | 24.74 | 67.57 | 352.42 |
| Noncurrent loans | 7.62 | 2.61 | 2.20 | 1.00 | 1.22 | 3.20 | 17.85 |
| Noncurrent RE loans | 3.66 | 1.47 | 0.92 | 0.30 | 0.56 | 1.60 | 8.51 |
| Noncurrent C&I loans | 1.42 | 0.59 | 0.70 | 0.27 | 0.45 | 0.73 | 4.16 |
| Noncurrent cnsmr loans | 2.35 | 0.47 | 0.52 | 0.35 | 0.15 | 0.70 | 4.53 |
| Other real estate owned | 1.17 | 0.54 | 0.19 | 0.09 | 0.17 | 0.83 | 3.00 |
| Securities not in trading account* | 109.54 | 73.69 | 60.19 | 32.94 | 59.49 | 47.59 | 383.43 |
| Total liabilities | 692.99 | 444.81 | 338.59 | 156.16 | 206.83 | 427.58 | 2,266.96 |
| Total deposits | 524.33 | 336.64 | 265.06 | 119.53 | 177.68 | 334.53 | 1,757.76 |
| Domestic deposits | 352.57 | 319.15 | 244.40 | 116.79 | 175.04 | 284.09 | 1,492.03 |
| Loan loss reserve | 11.52 | 5.21 | 4.34 | 1.95 | 1.96 | 7.30 | 32.28 |
| Equity capital | 59.96 | 37.87 | 30.69 | 13.78 | 19.44 | 44.51 | 206.25 |
| Total capital | 72.31 | 43.19 | 36.02 | 15.61 | 20.55 | 44.92 | 232.60 |
| **Balance Sheet Changes ($ billions)** | | | | | | | |
| **Year-to-Date Changes:** | | | | | | | |
| Assets | –45.33 | 46.39 | 2.17 | –0.84 | –1.05 | 68.39 | 69.73 |
| Loans | –13.95 | 48.85 | 13.07 | –1.00 | –4.06 | 46.92 | 89.83 |
| Noncurrent loans | –0.24 | 0.47 | 0.11 | 0.04 | 0.16 | –0.37 | 0.17 |
| Other real estate owned | –0.70 | 0.01 | –0.05 | –0.01 | –0.03 | 0.02 | –0.76 |
| Securities not in trading account* | –2.57 | –4.27 | –0.89 | –0.44 | –2.68 | 3.52 | –7.33 |
| Total liabilities | –42.38 | 41.49 | 0.68 | –1.12 | –2.10 | 56.88 | 53.45 |
| Total deposits | –30.36 | 35.63 | 1.06 | 3.72 | 4.59 | 47.30 | 61.94 |
| Loan loss reserve | –0.28 | 0.64 | 0.11 | 0.11 | 0.01 | 0.43 | 1.02 |
| Equity capital | –2.95 | 4.90 | 1.49 | 0.28 | 1.05 | 11.52 | 16.28 |
| Total capital | –4.00 | 5.94 | 2.56 | 0.04 | 1.23 | 6.18 | 11.95 |
| **Third Quarter Changes:** | | | | | | | |
| Assets | –93.61 | 6.40 | 7.37 | 3.30 | 0.83 | 7.53 | –68.18 |
| Loans | –41.93 | 11.23 | 10.06 | 0.72 | –0.39 | 3.13 | –17.18 |
| Noncurrent loans | –0.32 | 0.19 | 0.15 | –0.02 | 0.04 | –0.20 | –0.14 |
| Other real estate owned | –0.35 | 0.00 | –0.01 | 0.00 | –0.01 | –0.05 | –0.43 |
| Securities not in trading account* | –9.94 | –7.04 | 2.35 | –0.36 | –2.95 | 1.42 | –16.52 |
| Total liabilities | –88.81 | 5.48 | 5.89 | 3.14 | 0.63 | 7.28 | –66.40 |
| Total deposits | –66.58 | 9.30 | 6.10 | 3.09 | 3.04 | 7.76 | –37.29 |
| Loan loss reserve | –0.80 | 0.25 | 0.14 | 0.04 | 0.00 | –0.05 | –0.42 |
| Equity capital | –4.80 | 0.92 | 1.49 | 0.16 | 0.20 | 0.25 | –1.78 |
| Total capital | –7.80 | 0.91 | 1.64 | –0.19 | 0.02 | 0.33 | –5.08 |

*Beginning in 1994, securities classified by banks as "held-to-maturity" are valued at their amortized cost, and securities classified as "available-for-sale" are valued at their current fair value. Numbers may not add to total due to rounding.
Note: 1996 data are preliminary. 0.00 indicates a gain of less than $5 million.
Financial and Statistical Analysis (12/09/96)

# Glossary

## Definitions

*Commercial Real Estate Loans:* Loans secured by nonfarm, nonresidential properties.

*Construction Loans:* Loans for construction and land development.

*Extraordinary Income, Net:* Net after-tax income from events and transactions that are "unusual and infrequent."

*Failed/Assisted Banks:* National banks that have been closed by, or have received financial assistance from, the Federal Deposit Insurance Corporation (FDIC).

*Gains on Securities Sales, Net:* Net pre-tax realized gains (losses) on securities not held in trading account.

*Leverage Ratio:* Ratio of estimated Tier 1 capital to estimated tangible total assets.

*Loans:* Total loans and leases less unearned income.

*Net Loan Losses:* Total loans and leases charged off (removed from balance sheet because of uncollectibility) during the period, less amounts recovered on loans and leases previously charged off.

*Loan Loss Reserve:* The allowance for loan and lease losses.

*National Banks:* Nationally chartered commercial banks, trust companies without deposits, nonbank banks, and credit card banks in the United States and its territories that are insured by either the Bank Insurance Fund or the Savings Association Insurance Fund of the FDIC and filed a call report.

*Noncurrent Loans:* The sum of loans and leases 90 days or more past due plus nonaccrual loans.

*Net Interest Margin:* Net interest income as a percent of average assets.

*Other Real Estate Owned (OREO):* Real estate acquired by a bank for debts previously contracted (i.e., foreclosed real estate). Also includes property formerly used or intended for use for banking purposes.

*Regions:* Northeast (NE) — Connecticut, Delaware, District of Columbia, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, Pennsylvania, Puerto Rico, Rhode Island, Vermont, Virgin Islands; Southeast (SE) — Alabama, Florida, Georgia, Mississippi, North Carolina, South Carolina, Tennessee, Virginia, West Virginia; Central (CE) — Illinois, Indiana, Kentucky, Michigan, Ohio, Wisconsin; Midwest (MW) — Iowa, Kansas, Minnesota, Missouri, Nebraska, North Dakota, South Dakota; Southwest (SW) — Arkansas, Louisiana, New Mexico, Oklahoma, Texas; West (WE) — Alaska, Arizona, California, Colorado, Guam, Hawaii, Idaho, Montana, Nevada, Oregon, Utah, Washington, Wyoming.Each bank in a multinational bank holding company is included in the region in which the bank is located.

*Residential Real Estate:* Loans secured by one- to four-family and multifamily (five or more) residential properties.

*Risk-based Capital (RBC) Ratio:* Ratio of estimated total capital to estimated risk-weighted assets.

*Securities Not in Trading Account:* Total securities excluding those held in trading accounts. Beginning in 1994, securities classified by banks as "held-to-maturity" are valued at their amortized cost, and securities classified as "available-for-sale" are valued at their current fair value.

*Total Capital:* The sum of Tier 1 and Tier 2 capital. Tier 1 capital consists of common shareholders equity, perpetual preferred shareholders equity with noncumulative dividends, retained earnings, and minority interests in the equity accounts of consolidated subsidiaries. Tier 2 capital consists of subordinated debt, intermediate-term preferred stock, cumulative and long-term preferred stock, and a portion of a bank's allowance for loan and lease losses.

## Computation Methodology

Current quarter income statement items were calculated by summing the difference between the year-to-date and previous quarter numbers of each item for all banks that filed a current quarter call report. For performance ratios constructed by dividing an income statement (flow) item by a balance sheet (stock) item, the income statement item for the period was annualized (multiplied by the number of periods in a year) and the average of the balance sheet item for the period (beginning-of-period amount plus end-of-period amount divided by two) was used.

# Recent Corporate Decisions

## Interstate Transactions

On July 9, 1996, Bank of America NT&SA, San Francisco, California, received approval to merge with its New York affiliate, BankAmerica National Trust Company, New York, New York, under the early opt-in provision of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (hereinafter, "Riegle-Neal").

On July 18, 1996, FNB of Maryland, Baltimore, Maryland, received approval and established branches in the District of Columbia and another branch in Virginia, under the early opt-in provision of Riegle-Neal. In addition, on July 25, 1996, FNB of Maryland was granted approval to acquire Washington Federal Savings Bank, Herndon, Virginia, under the authority of 12 USC 215c. Washington Federal has branches in the District of Columbia, Maryland, and Virginia.

On August 2, 1996, Sun World, N.A., El Paso, Texas, a subsidiary of NationsBank, received approval to relocate to Santa Teresa, New Mexico, and establish a branch at its previous head office site.

On August 6, 1996, The FNB of Boston, Boston, Massachusetts, received approval to merge with BayBank, N.A., Boston, Massachusetts. BayBank is an interstate bank with branches in Massachusetts and Connecticut. BayBank also held nonconforming money market preferred stock that the OCC permitted it to retain when it converted to a national bank. The approval allows the resulting bank to hold the money market preferred stock for two years unless the OCC extends the period.

On August 7, 1996, Franklin National Bank of Virginia, Alexandria, Virginia, received approval to relocate to the District of Columbia, establish a branch at its previous head office site, and merge with and into its DC affiliate. This was the first interstate relocation from Virginia to DC. Prior to filing this proposal, Franklin established its first branch in Virginia and another in Maryland under the early opt-in provision of Riegle-Neal.

On August 8, 1996, CoreStates Bank, N.A., Philadelphia, Pennsylvania, received approval to acquire Delaware Trust Company, Wilmington, Delaware, a state-chartered affiliate. This is the first Riegle-Neal merger between these two states. Delaware Trust Company owns a full service state-chartered bank, as a subsidiary, that limits its activities to fiduciary, investment management and other related services. The subsidiary is not a bank for federal Bank Holding Company Act purposes, as it is not an "insured bank" and it neither accepts demand deposits nor makes commercial loans. Thus, CoreStates will not be a bank holding company. The subsidiary holds an inactive insurance license. CoreStates committed that it would not activate the insurance license without OCC's prior approval.

On August 9, 1996, Crestar Bank, N.A., Washington, DC, received approval to relocate its head office to Vienna, Virginia, and establish a branch at its former head office site. The relocation was filed to accommodate the future consolidation of the three Crestar banks (one national and two state) under a state charter.

On August 20, 1996, Mellon Bank, N.A., Greensburg, Pennsylvania, received approval to merge with its affiliated banks in New Jersey and Maryland under the early opt-in provision of Riegle-Neal. These were the first Riegle-Neal mergers to be approved for a national bank in Pennsylvania to merge with banks in the states of New Jersey and Maryland.

On August 20, 1996, PNC Bank, N.A., Pittsburgh, Pennsylvania, received approval to merge into its affiliate, Midlantic Bank, N.A., Newark, New Jersey, under the early opt-in provision of Riegle-Neal. The resulting bank will retain the PNC title and be headquartered in Pittsburgh.

On August 23, 1996, First National Bank of McConnellsburg, Pennsylvania, received approval to establish a de novo branch in Hancock, Maryland, under the early opt-in provision of Riegle-Neal. This would be the second de novo branch to be established in Maryland by a national bank in Pennsylvania.

On August 28, 1996, Union Planters, N.A., West Memphis, Arkansas, received approval to relocate its head office to Memphis, Tennessee, establish a branch at its previous head office site, and merge into its affiliate, Union Planters National Bank, Memphis, Tennessee. This was the first approval for a national bank to relocate from Arkansas to Tennessee.

On August 31, 1996, Wells Fargo Bank, N.A., San Francisco, California, received approval to merge with its affiliate, Wells Fargo Bank of Arizona, N.A., Phoenix, Arizona (formerly First Interstate Bank of Arizona, N.A.) under the early opt-in provision of Riegle-Neal. Arizona's opt-in law became effective on August 31, 1996.

On September 20, 1996, Century National Bank, Washington, DC, received approval to establish a branch in McLean, Virginia, under the early opt-in provision of Riegle-Neal.

On September 24, 1996, American National Bank & Trust Company, Danville, Virginia, received approval to purchase the assets and liabilities of the Yanceyville, North Carolina branch and related CBCT of FirstSouth Bank, Burlington, North Carolina. This was the first purchase and assumption of a branch to be approved for a national bank under the early opt-in provision of Riegle-Neal.

On September 27, 1996, Douglass Bank, Kansas City, Kansas, received approval to convert to a national bank with trust powers, perform a quasi-reorganization of its capital accounts, relocate to Kansas City, Missouri, and establish a branch at its former head office site. The bank's holding company, Douglass Bancorp, was recently awarded funding from the Community Development Financial Institution Fund. However, the bank did not seek designation as a bank with a community development focus, which would have made it eligible for national banks to purchase its stock under 12 CFR 24.

On September 30, 1996, Union Planters National Bank, Memphis, Tennessee, received approval to merge with its recently acquired affiliate, Leader Federal Savings Bank, Memphis, Tennessee, and acquire four DeSoto County, Mississippi branches and two CBCTs from two other affiliated banks. This was the final step in bringing all affiliated branches located in the Memphis Metropolitan Area under the same charter. Union Planters also received approval to continue operating six operating subsidiaries of Leader Federal. Two of the operating subsidiaries conduct activities that are impermissible for a national bank (insurance and real estate development). Union Planters was allowed to retain the subsidiaries based on its committment to bring the subsidiaries' activities into conformance with permissible activities for a national bank prior to consummating the merger. Two CRA-related protests were received and thoroughly investigated by the OCC. Our findings did not lead us to question Union Planters' "Satisfactory" CRA rating or to condition the approvals.

On September 30, 1996, Connecticut River Bank, Charlestown, New Hampshire, received approval to convert to a national bank, relocate to Springfield, Vermont, and establish a branch at its former head office site. The bank was also granted approval to retain shares of common stock in two utility companies based on representations that it will dispose of the stock when the stock's market value equals or exceeds cost.

## Charters

On July 18, 1996, TCF Financial Corporation, Minneapolis, Minnesota, received approval to charter a national bank in each of four states: Illinois, Michigan, Minnesota, and Wisconsin. The banks will have stand-alone head offices, separate management teams, and slightly different boards from the affiliated thrifts. However, each bank will operate in tandem with the thrifts, in the sharing of branches and employees. TCF committed to complying with current and any future guidelines the agency may issue on tandem operations. The purpose of the banks is to facilitate the migration of deposits from SAIF to BIF, and to further TCF's business shift toward that of a commercial bank. The proposal was protested by the American Bankers Association and a number of others on the grounds that it violates the SAIF conversion moratorium. The FDIC and OCC concluded that voluntary deposit migration between affiliated institutions did constitute a violation of the conversion moratorium under the FDI Act.

On August 2, 1996, Great Western Financial Corporation, Chatsworth, California, received approval to charter two national banks, one in California and another in Florida. The charter proposals are similar to the TCF transaction discussed above.

On July 18, 1996, Fingerhut Companies, Inc., received conditional approval to charter a national CEBA credit card bank in Sioux Falls, South Dakota. The proposed bank is to be entitled, "Fingerhut National Bank." Fingerhut is the second largest catalog marketer of consumer products sold in the United States. The proposed bank is to offer a private label card restricted to Fingerhut customers for the purchase of propriety products on a closed-end credit basis. The Federal Reserve reviewed the appropriateness of a CEBA credit card bank offering a closed-end credit product and issued a No Objection letter. In addition, based on OCC No Objection Letter 93-01, OCC concluded that the bank is not a depository institution for the purposes of the Depository Institutions Management Interlocks Act, 12 USC 3201, as long as it does not accept deposits from the public. Consequently, the OCC had no objection to an individual serving as director of both the proposed bank and another bank located in Sioux Falls. The proposed bank also received approval to be considered a limited-purpose bank under the Community Reinvestment Act. The conditions to the approval were the normal conditions the OCC imposes on CEBA credit card bank charters.

On July 25, 1996, Diamond Shamrock Refining and Marketing Company, San Antonio, Texas, received conditional approval to charter a national CEBA credit card bank in Albuquerque, New Mexico, to be entitled,

"DSRM National Bank." Diamond Shamrock is a regional refiner and marketer of petroleum products, with more than 2,000 outlets throughout the southwestern United States. The proposed bank also received approval to be considered a limited-purpose bank under the CRA. The conditions to the approval were the normal conditions the OCC imposes on CEBA credit card bank charters.

### Operating Subsidiaries

On July 15, 1996, First National Bank of Maryland, DC, Washington, DC, received approval to establish one or more operating subsidiaries to acquire title to and hold other real estate owned. Approval was also granted for the bank to make investments, through an operating subsidiary, in one or more limited liability companies in conjunction with other participants in loans secured by real property. The approvals were subject to the standard conditions for minority investments in other entities.

On September 11, 1996, Texas Commerce Bank, N.A., Houston, Texas, received approval to establish an operating subsidiary that will hold a 50 percent interest in two limited liability companies. Sallie Mae will hold the other 50 percent. The first LLC will market student loans originated by other affiliated banks of Chase Manhattan Corporation. The second LLC will acquire newly originated student loans from the Chase banks as well as acquire the banks' existing student loan portfolios. Sallie Mae will service the loans. The approvals were subject to the standard conditions for minority investments in other entities.

On September 20, 1996, The First National Bank of Chicago, Chicago, Illinois, received approval to establish a new operating subsidiary that will sell synthetic variable rate municipal bonds, a derivative product that combines the tax-exempt characteristics of a municipal bond with a variable rate of return. The subsidiary will form a series of trusts, organized as partnerships. Each trust will hold a single issue of bonds from a single obligor. The trusts will issue interests that the bank will sell by private placement to a limited number of institutional investors.

### Mobile Branch

On September 25, 1996, Fleet National Bank, Springfield, Massachusetts, received approval to establish a mobile branch in Connecticut. This will be the first mobile branch to be approved for a national bank in the State of Connecticut, since the OCC suffered a setback in a mobile branching case (see Brown v. Clarke, 1989). Earlier this year, Connecticut enacted a mobile branching law. The new law requires that each site be predetermined and satisfy certain qualitative review factors in order to receive regulatory approval. The OCC approved 12 initial sites and will process additional sites as requested.

# Appeals Process

## Case One: Appeal of CAMEL Rating

### Background

A formal appeal was received from a bank, which disagreed with the composite CAMEL rating of "3," assigned during their most recent safety and soundness examination. The bank's chairman provided a summary of the bank's view of the more significant misstatements and omissions of fact included in the Report of Examination (ROE):

1. The decline in the Tier 1 capital to assets ratio was the result of significant asset growth. During 1995, the bank acquired a portfolio of approximately 20 international deposit-backed loans totaling over $40MM. The loans were transferred directly from another bank, no international currency transactions or wire transfers took place from banks outside the United States. The bank had more than 5 years experience in handling international deposit-backed loans. The loans have been reviewed at two special OCC exams and the underwriting was never criticized by the OCC.

2. The bank always has the option to not renew the short-term international deposit-backed loans, which would significantly increase the bank's Tier 1 capital ratio. The bank recently initiated this control and raised the Tier 1 capital ratio to approximately 7 percent by the nonrenewal of those loans.

3. Although the bank's Tier 1 leverage capital ratio did decline in 1995, the actual dollar amount of Tier 1 capital grew by over $1MM, a 40 percent increase. This growth was primarily attributed to an increase in interest income, which was generated by (a) the deposit-backed loans, (b) the increase in value of the bank's mutual fund portfolio, and (c) a capital injection by the bank's owner.

4. The bank's mutual fund investments were also subject to OCC reviews and have been re-examined numerous times over the five years the bank has managed this portfolio. The interest rate risk was never mentioned as a major concern of the OCC prior to this exam.

5. Although this is the first time the OCC has recommended that the bank's capital plan include the impact of fluctuations in interest rates and that the bank's written policies set forth procedures to control and inform the board of directors of interest rate risk, the board has regularly been apprised of the degree of interest rate risk and its impact on capital and earnings and has always accepted those levels as manageable.

In the appeal letter the chairman also stated that while the bank does not agree with the conclusions drawn by the OCC or the degree of severity afforded many of their concerns, the board and management have already taken the following action to resolve the major concerns as follows:

1. The ROE indicates that Tier 1 capital is inadequate at 4.24 percent as of year end. Since the bank's request for an exception to operate the bank below the minimum ratio was not granted, the board of directors passed a resolution to increase Tier 1 capital to 6 percent within 90 days by controlling the renewal of the deposit-backed international loans.

2. The bank has disposed of all of its mutual fund investments to reduce their impact on capital and earnings from interest rate risk.

The chairman also noted that at the time of appeal the bank's Tier 1 leverage ratio was already approximately 7 percent.

### Discussion

During the third quarter of 1995, the bank acquired a portfolio of loans made to foreign corporations and individuals secured by third party certificates of deposit (offshore shell corporations). On September 30, 1995, the bank reported a Tier 1 leverage ratio of 4.05 percent due to the funding of the $40MM in deposit-backed international loans during the third quarter. A month later the bank requested authority to operate with less than the minimum Tier 1 leverage ratio required under 12 CFR 3.6. The bank's request for an exemption was not granted. As of December 31, 1995, the bank's Tier 1 leverage ratio was 4.24 percent.

The bank's ROE describes the Office of the Comptroller of the Currency's (OCC's) primary concern as the drop

in the bank's Tier 1 capital as a percent of adjusted total assets (leverage ratio) to an unacceptable level. The drop in the leverage ratio was a result of the bank significantly increasing their holdings of loans to foreign corporations and individuals secured by third party certificates of deposit. Because of the drop in capital ratios, the bank's supervisory office also became very concerned about the levels of interest rate risk, the bank's earnings, and the supervision by management and the board of directors.

Subsequent to the examination the board of directors passed the following resolution:

> BE IT RESOLVED, that steps will be taken to reduce the number and amount of international loans so that a capital-to-assets ratio of no less than 6 percent is attained within ninety days and, that future international loan business would not cause the bank to fall below 6 percent.
>
> BE IT RESOLVED, that the bank's mutual fund holdings will be disposed of within the next 30 days.
>
> BE IT RESOLVED, that at this time, mutual funds will not be considered an appropriate investment for the bank.

Through runoff of a portion of the bank's deposit-backed loans, the bank's Tier 1 capital ratio was approximately 7 percent at the time of the appeal and the bank had disposed of all of its mutual fund investments.

## Conclusion

The significant growth in the deposit backed loans during 1995 materially changed the bank's risk profile. The ombudsman concluded that at the time of the examination the "3" rating assigned in the bank's most recent ROE was appropriate. However, the subsequent actions taken by the board to resolve the OCC's major concerns changed the risk profile of the bank to the point of justifying a new examination. The ombudsman requested the supervisory office to schedule an examination to reassess the bank's current condition.

Material Subsequent Event: The bank was recently re-examined by the supervisory office and the bank's composite CAMEL rating was upgraded to a composite CAMEL "2."

# Case Two: Appeal of Violation of Dividend Calculation

## Background

A bank disagreed with a violation of 12 USC 60(b) pertaining to the declaration and payment of an illegal dividend in December 1994. The disagreement involves the *calculation* of the maximum allowable dividends the bank could have paid. Three issues are involved:

- *Stock Dividend.* Bank managers do not believe that a stock dividend paid in 1993 is a dividend for purposes of 60(b). Therefore, they do not believe it should be included in the calculation.

- *Intercompany Payment.* The appeal also disputes the designation of an intercompany payment as a dividend for the purposes of this statute. In early 1994, the bank's parent company formed the existing bank through a complex, multistep, reverse acquisition of a predecessor bank. Among the steps in the transaction, the parent formed an interim national bank. With the prior concurrence of the OCC, the predecessor bank lent the parent a portion of the funds it used to initially capitalize the interim bank. The interim bank was then merged with the predecessor bank into the appealing bank's existing charter. Immediately following the merger, the appealing bank "declared a cash dividend" to its parent in the amount of the initial capitalization. The parent then used the proceeds to repay the loan to the predecessor bank (now the appealing bank) and replenish the holding company's cash. The entries did not have any impact upon the bank's capital levels, i.e., its capital immediately following the merger and after the dividend was exactly the same.

- *Accounting Adjustments.* The examiners identified errors in the bank's official reports during an examination that began November 28, 1994. Year-to-date September 30, 1994 earnings were revised from a small net income to a large net loss due to understated goodwill associated with certain acquisition costs, loan charge-offs, and ALLL balance. Additionally, the bank discovered in March 1995 that the intercompany payment was apparently not accurately reported on its call report. The bank believes it properly relied on its call report, as originally filed, in calculating the maximum divi-

dend for purposes of the December 1994 dividend.

## Discussion

The statute, 12 USC 60(b) requires a bank to obtain prior OCC approval if the total of all dividends declared in any one calendar year exceeds the total of its net income of that year plus the retained net income (net income less dividends) for the preceding two years.

*Stock Dividends.* The statute is silent on the application of stock dividends. The OCC's historical position has been that stock dividends are dividends for purposes of section 60(b). *See, e.g.,* Letter from William B. Camp, Comptroller, to Manuel F. Cohn, Chairman, SEC (April 8, 1968) and Letter from Donald G. Coonley, Chief National Bank Examiner (September 10, 1992). However, the OCC has not made its historical position clear to all banks by regulation or otherwise. Also, the Board of Governors of the Federal Reserve System has issued a policy statement specifically stating that stock dividends are not to be taken into account for purposes of section 60(b). See 1960 Fed. Res. Bull. 858. Since a stock dividend does not result in the distribution of cash or assets, the board does not consider the term "dividend" in this statute as including stock dividends.

*Intercompany Payment.* The bank made this intercompany payment solely to facilitate a complex, multistep, reverse acquisition of another institution. The legislative history of the statute indicates that its intent was to protect the capital of national banks. It provides the OCC with a legal mechanism to prevent national banks from dissipating their capital through dividend payments. Despite the fact that the bank made this intercompany payment out of its undivided profits account, all of the bank's accounts after the acquisition were the same as all of the predecessor bank's accounts before the acquisition. The acquisition merely involved a transfer of funds from its capital stock and surplus accounts to its undivided profits account. Viewing the bank as a de facto continuation of the predecessor bank, the multistep transaction did not alter the bank's overall capital or cash positions.

*Accounting Adjustments.* The largest decrease to earnings resulted from an inadequate ALLL balance based upon loans downgraded by the OCC and external loan review. Two loan losses accounted for one-half of the increases to the ALLL. The examiners also identified inadequate accounting controls that resulted in additional adjustments regarding prepaid expenses, accounts receivable, OREO losses, overdrafts, and miscellaneous other expenses. As a result, the examiners cited the bank in violation of 12 USC 161 (inaccurate call reports). OCC Banking Bulletin 90-44 directs national banks to use the net income amount reported in its call report in calculating its dividend-paying capacity under 60(b). Underlying this guidance is the assumption that the net income amount in the call report is accurate, i.e., reported in compliance with all applicable reporting requirements.

## Conclusion

The ombudsman concurs with the bank's appeal that both the stock dividend and the intercompany payment involve unique considerations. He also agrees that, in economic reality, neither payment contravenes the statutory purpose of preventing the dissipation of bank capital. Therefore, he decided that neither payment is a dividend for the purposes of 12 USC 60(b).

However, the violation of 12 USC 60(b) remains. The bank refiled its March, June, and September 1994 call reports to correct the errors identified as a result of the examination. The income and dividend numbers based on those corrections still reflect the payment of excessive dividends, *excluding* the stock dividend and the intercompany payment.

# Speeches and Congressional Testimony — July 1 to September 30, 1996

# Remarks by Konrad S. Alt, Senior Deputy Comptroller for Economic Analysis and Public Affairs, before the Financial Services Technology Consortium, on electronic money and banking, July 11, 1996

I have heard good things about the Financial Services Technology Consortium for quite a while now. You clearly have a significant leadership role in the arena of electronic money and banking. As we all know, there some difficult issues to be addressed in this arena — issues with broad implications. I speak for many of my colleagues at the OCC and the Treasury Department in saying that we are grateful for the contributions you have already made to helping find solutions to these challenges, and we have high hopes and expectations for your efforts going forward.

When Jim Luisi invited me to speak, he asked that I give an overview of the current legislative and regulatory climate as it relates to electronic money and banking. But let me begin with a little bit of background. Many of you have been active in this area for a good long time. I only got started in it about a year ago, and when I did, my ears were still ringing — perhaps I should say burning — with Bill Gates' famous statement to the effect that banks are dinosaurs. Few people in the world at large stopped to think about the implications of that statement for bank *regulators,* but — let me tell you — they weren't lost on me.

So I came to the field of electronic money with the clear understanding that, if banks are dinosaurs, then my job as a regulator is to prevent the Age of Mammals — an uphill battle, but maybe we can learn something from experience.

That is how I thought about it for a few months, until my oldest boy, Wyatt, started to do what I suppose pretty much all 4-year-old boys do — become obsessed with dinosaurs. Of course, initially, I was relieved: at least he wasn't obsessed with mammals. But then he did another thing that I suppose pretty much all 4-year-old boys do, and that was drag his dad down to the Museum of Natural History. And I learned something very interesting there.

And what I learned was this: dinosaurs didn't die out after all. Back when I was a kid, that is what the museums taught. But today's 4-year-olds get a very different story. They're told that dinosaurs never died out, they evolved into birds. So it turns out, banks and their regulators don't have to worry about stopping the Age of Mammals after all. *We have to learn to fly.* That too is pretty challenging, but you have got to admit it's a more inspiring project, isn't it?

Inspiring and interesting, but now — as they say — back to the program. What I would like to do today is start by giving something of an overview of what has been going on in the area of electronic money in Washington over the past couple of years. Then I will talk a little bit about what I believe are the emerging areas of public policy concern that will have to be addressed, perhaps not next month or next year, but clearly before electronic banking and electronic commerce can realize its potential.

Let me start with an overview of what's been happening on Capitol Hill and in the regulatory community — and I want to confess right up front that this overview goes well beyond the initiatives in which I am personally involved, so I reserve the right to duck hard questions on some of the specific items here. Easy questions, of course, are always welcome.

## The 104th Congress

In the electronic money area, the record of the 104th Congress in a nutshell is one of minimal legislation, limited legislative proposals, and reasonably extensive oversight.

The only significant enactment in the area of electronic money this year is a provision in the Omnibus Appropriations Act of 1996 requiring that all federal payments after January 1, 1999 be made by electronic funds transfer. Federal payments include everything from federal wages and retirement payments to social security and veterans benefits. There is one notable exception, however. Federal tax refunds will, for the foreseeable future, continue to be dispensed the old-fashioned way, allowing the IRS to hold on to your tax dollars for a few more precious hours.

So much for the small category of legislative accomplishments. The category of legislative proposals a bit more extensive. This session, three bills were introduced to address the issues relating to the use and distribution of encryption technology, as it applies both domestically and internationally. All of these bills seek to encourage the use of strong encryption domestically by expanding its potential market. However, all of them are at odds with the administration's expressed preference for an escrow system in which a third party would maintain copies of decryption keys. None of them, in view of the distractions of an election year and

the short calendar, appear to have much chance of enactment in the 104th Congress.

Although its legislative activities in the area of electronic money have been limited, the 104th Congress's oversight activities have been much more extensive.

Notable on this front were a series of hearings held in the House Banking Committee's Domestic and International Monetary Policy Subcommittee chaired by Representative Michael Castle (R-Del.) These "Future of Money" hearings included four hearings with testimony from U.S. and foreign financial regulators, national and foreign technology and banking industry principals and security experts. Just yesterday, the Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises chaired by Congressman Richard Baker (R-La.) began hearings on how technology has affected and will affect the financial services industry.

On the Senate side, the Government Affairs Committee's Permanent Subcommittee on Investigations is holding a series of hearings on Security in Cyberspace. Senator Sam Nunn (D-Ga.), the ranking member of the subcommittee, has taken the lead on the hearings, which will conclude on July 16, 1996 with the fourth and final hearing. Further, the Senate's Commerce, Science, and Transportation Committee's Science, Technology and Space Subcommittee — chaired by Senator Conrad Burns (R-Mont.) — held hearings relating to the encryption bills the Senator introduced this session.

### The Regulatory Community

Let me now move off the Hill and talk briefly about some of the activities underway within the regulatory community and the Treasury Department.

First, a few imminent regulatory actions of a formal nature that may be of interest.

- The FDIC Board at its next board meeting will consider whether to issue an opinion letter advising depository institutions that most categories of so-called stored-value cards do not carry deposit insurance protection.

- The Financial Management Service will — in the next few weeks — issue a final rule to implement federal payments requirements included in the Omnibus Appropriations Act I mentioned earlier.

- The Federal Reserve has proposed revisions to its Regulation E (Electronic Fund Transfer Act) to cover, in part, stored-value cards. The comment period ends August 1.

Below this rather modest amount of formal activity, a lot of informal activities are underway. And here I will focus especially on what's going on in various corners of the Treasury, and especially in my little corner.

Within Treasury, the OCC — for those of you unfamiliar with the agency I represent — is responsible for supervising nearly 3,000 national banks. These banks account for 56 percent of the country's commercial bank assets.

In August 1995, Treasury Secretary Rubin asked my boss, Comptroller of the Currency Gene Ludwig, to coordinate the activities of the Treasury Department involved in electronic money and banking. The Treasury Department is a large, disparate organization, with various connections to and interests in the electronic money area. Those interests range from regulation of financial institutions — the area I work in — to the enforcement of laws relating to financial crimes, which is the province of Treasury organizations like the Secret Service, FinCen, and the Customs Service. They also include a variety of operational interests in how electronic money and payment systems might affect or facilitate government payments, government collections, and the demand for government-issued coin and currency. Those operational interests reside in places like the Financial Management Service, the IRS, the Mint, and the Bureau of Engraving and Printing.

Consequently, Treasury is engaged in this area on a number of fronts. Just to give a few examples you may be familiar with, Treasury's Financial Management Service is an advisory member of your Electronic Check program and is working with the states to implement Electronic Benefits Transfer by 1999. EBT is targeted for individuals who receive government benefits, but do not have banking accounts. The Office of Thrift Supervision chartered and now supervises First Security Network Bank, a federal thrift whose business plan centers on electronic banking and the electronic distribution of financial products and services.

I should also note that in September, Treasury will sponsor an Electronic Money Conference — focusing on the role of government — at the Washington Sheraton on September 19 and 20. I hope many of you will be able to attend.

In support of the Secretary's request, the OCC plays a coordinating role for the entire Department with respect to the development of policy on electronic money. This isn't coordination in the sense of telling the rest of the Department what to do, but only in the sense that we try to function as something of a clearinghouse for

information, analysis, and concerns. In that capacity, we have sponsored a long series of educational briefings and hosted periodic discussions on emerging issues at the bureau head level. In the process, we have met with representatives from leading financial services institutions, firms on the cutting edge of new technologies and foreign regulators to stay abreast of the latest thinking and developments in these areas.

And, of course, the OCC also has our bank supervision responsibilities to worry about, so we have assembled a Banking Technology Committee comprised of bank examiners, economists, and lawyers to develop guidance for banks and our examination force. Over the next year or so, this committee will assess the nature and extent of risk exposure emerging technologies present, draft bank and examiner guidance, and identify agency training needs.

Now, the overview I have just given isn't complete, by any means, but I think it can form the basis for some general observations about how Washington is proceeding in this area. Let me offer two such observations. First, although the number and scale of formal actions to date is small, the amount of activity is considerable. Plainly, the issues surrounding electronic commerce are very much on the radar screen of the regulatory community.

Second, the attitude that seems to pervade the actions of the Congress, the executive branch, and the agencies is, wait and see. There is widespread, bipartisan interest in developing a solid understanding of the emerging technologies and issues before taking actions that could jeopardize the market from developing rapidly and evolving efficiently. In effect, we are seeing a governmental effort to adhere to the key principle of the Hippocratic Oath: do no harm. And that is pretty much what you would hope policymakers would do at a time when technology and markets are still defining the course electronic commerce will take in the years to come.

I want to emphasize that you should not confuse this wait-and-see posture with inaction or a laissez-faire philosophy. Things are happening — a substantial education effort is underway, and policymakers are moving pretty quickly along the learning curve. And I think we are also beginning to see, if not a generally shared understanding of what government's ultimate role in this area should be, at least some emerging consensus on the public policy issues that government may eventually have to address.

What are those emerging areas of consensus? There are three, I believe: consumer protection, law enforcement, and international cooperation.

### Consumer Protection

There are a number of consumer protection issues looming. Certainly the issue that has received the most airplay to date is privacy, a very real concern and one we are all quite familiar with. Suffice it to say that these concerns need to be fully debated and addressed.

I want to highlight some of the other consumer protection concerns with a personal illustration. Several months ago, my wife — whose job entails a demanding travel calendar — skipped town on a weekend, leaving me in custody of our three small boys. Of course, there is only one way to keep three little boys under control and that is to strap them down somewhere. And the only place where I can legally strap all three of them down is in our car. So that is how I came to find myself driving aimlessly across the Maryland countryside on a Sunday afternoon looking, as usual, for coffee.

Now there are not very many Starbucks out there in the Maryland countryside. But, thank heaven, we have 7-11s by the score. Besides, for my money, that's the only place one really can find an earthy cup of coffee. I think it has something to do with their schedule for rinsing out the pots.

In any event, as I pulled up to this particular 7-11, I saw in the window a big poster of a football quarterback. And on closer inspection, it turned out to be an ad for 7-11's stored value product, which is a telephone card sold in a variety of denominations and redeemable in MCI long distance units. Now I thought, that's funny — so I asked the clerk some questions about it: Who underwrites this card? Can I see some financials on the issuer? If the card gets damaged, who is liable for any unredeemed balance?

As it turned out, all of these questions received the same answer: Huh?

Unfortunately, before I could ask a follow-up question, she'd moved on to the 7-year-old standing behind me with a Slurpee. But her answer points out several public policy problems. If we want this marketplace to work rationally and efficiently, we need consumers to understand what they're buying, and we need an effective mechanism for developing that understanding. That need becomes increasingly urgent as you move up the scale from comparatively closed electronic money systems toward more open systems. We do not currently have in place an adequate set of rules to ensure that consumers can get the information they want even if they ask for it, let alone have it made available routinely. Consequently, consumers may not know where to turn if they lose a card. They may not appreciate the differences between money — backed by the government —

and stored value — backed by private issuers. And they may not be able to make informed choices between different private issuers to protect themselves against the risk of loss due to default. That is a potentially serious problem in the absence of a regulatory regime that ensures adherence to basic tests of financial strength across the full universe of stored value issuers.

### Law Enforcement

A second area of clear importance is law enforcement. The issues here are largely familiar — counterfeiting, money laundering, tax evasion, and perhaps most importantly, fraud.

We have faced all of these problems in the world of physical money since time immemorial. We have never solved them. But by dint of a reasonable amount of vigilance and aggressive action when necessary, we manage to contain them well enough that fear of loss does not inhibit average citizens from using physical money in ordinary commerce.

Controlling these problems adequately in the realm of virtual commerce, however, will present some special challenges. The costs of developing new high-tech systems to detect and deter financial crimes in cyberspace could be significant, and money for new government programs is generally hard to come by these days. Moreover, the international character of cyberspace raises the need for new bodies of civil and criminal law to ensure both the orderly conduct of international electronic commerce and the ability to bring international electronic financial criminals to justice.

### International Cooperation

And this brings me to the third issue, which is the need for greater international cooperation.

The observation that the Internet is borderless is by now a cliché. But the regulatory and industry issues this fact presents are novel. There is no clear understanding among the world's financial regulators as to the allocation of responsibilities for monitoring and acting to prevent financial frauds on the Internet. There is not yet a way for consumers to be certain, in the Internet environment, that the financial institution they believe they are dealing with is legitimate or that the transaction in which they are engaged is enforceable. It will take time and a great deal of effort to develop both international cooperation and an administrative structure to address the international ramifications of truly global electronic commerce on the Internet.

At the recent G-7 summit, member nations agreed to Secretary Rubin's proposal to establish a one-year study effort to examine e-money and banking issues at an international level. This research will build upon work already underway at the Bank for International Settlements, the Basle Committee, and the Financial Action Task Force, an international law enforcement group.

The study will hopefully bring together various interests and identify gaps in existing efforts, but the wheels of international cooperation grind exceedingly slowly. We should all anticipate that resolving the international issues associated with electronic commerce will be the work of decades, if not generations.

### Conclusion

So where does that leave us? In many ways, that ball is in your court, because government is looking to you to help us work through the challenges I have talked about this morning.

As *The American Banker* observed recently, there has been a "sea change in Washington's relationship to the high-technology community." In my experience, that sea change is real. It is long overdue. And it creates new roles and opportunities for us all. From government, that changed role brings a genuine desire to develop laws, policies, and systems that make technological and economic sense for the long-term and do not get in the way of market evolution. And from you, that new relationship brings new opportunities to apply your expertise to the cause of making new technology a safe, efficient and effective tool for commerce and the provision of government services. These are interesting and exciting times for all of us — the FSTC, the financial services industry, policymakers, and regulators as we strive to address sea changes together and in a way that serves the interests of our consumers and the country.

# Statement of Eugene A. Ludwig, Comptroller of the Currency, before the Subcommittee on Financial Institutions and Regulatory Relief of the Senate Committee on Banking, Housing, and Urban Affairs, on consumer credit, Washington, DC, July 24, 1996

*Statement required by 12 USC 250: The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.*

Mr. Chairman and members of the Subcommittee, I appreciate this opportunity to testify on the condition of consumer credit in the United States. Over the past few years we have seen a rise in consumer loan delinquencies and loss rates. As bank supervisors, we are concerned about these trends and are taking steps to ensure the continued safety and soundness of the national banking system. Nonetheless, it is important to place these developments in perspective in order to react appropriately.

In that context, we must recognize that the economy is strong. The nation's banks have recorded four consecutive years of record profits, and figures for the first quarter of 1996 — although not a quarterly record — are quite strong. Preliminary indications are that second quarter earnings will also be strong. Bank capital levels are at their highest levels in years. Problem commercial banks totaled 127 as of March 1996 compared with over 1,000 at the end of 1991. For the first six months of 1996, three commercial banks have failed, compared with 55 in the first six months of 1991.

Today I will discuss what is happening in consumer lending in the commercial banking system, where we see areas of concern, and what the Office of the Comptroller of the Currency (OCC) is doing to address current and potential problems in consumer credit and bank safety and soundness. I will begin my testimony with a discussion of developments in the roles that banks are playing in financing larger amounts of consumer debt. Next, I will discuss the rise in credit problems. I will then outline the major recent initiatives that the OCC has undertaken in supervision of consumer lending.

## Banking Industry Consumer Loan Trends

Over the past 10 years, commercial banks have shifted into consumer lending residential real estate lending such as home mortgages and home equity loans, installment lending such as automobile and boat loans, and credit cards. The largest and fastest growing area of consumer lending is in loans secured by residential real estate. This includes 1-to-4-family residential real estate loans, with a small volume of home equity loans. Residential real estate loans now account for nearly 15 percent of bank assets, compared with 7 percent at year-end 1984. Installment loans have grown at a slower rate. In 1984, installment loans were the largest component of consumer lending, at approximately 10 percent of commercial bank assets. Installment loans' share of assets declined between 1985 and 1992 and now account for 7 percent of assets. Although credit card loans account for less than 5 percent of total commercial bank assets, this category has grown faster than other types of consumer loans over the last three years.

Some banks concentrate their lending efforts in one type of consumer loan. A small number of commercial banks, 134, have a portfolio of credit card loans that exceeds 10 percent of assets. At 62 banks (42 of which are national banks), credit card loans exceed 50 percent of assets. By comparison, a larger number of commercial banks, 1,096, have residential real estate loans that represent more than 30 percent of assets. We find that the overall increase in consumer lending has caused total consumer loans-to-assets ratios to increase at certain banks. A larger percentage of banks today are more likely to have consumer loans-to-assets ratios of more than 30 percent, 40 percent, or 50 percent than in 1984. In fact, 35 percent of all commercial banks have a consumer loans-to-assets ratio of more than 30 percent, compared with 26 percent of all commercial banks at year-end 1984.

This shift into consumer lending occurred as traditional business customers increasingly went directly to credit markets or nonbanks for funding, therefore slowing the growth rates for commercial lending at commercial banks. Commercial banks also reduced their loans to less developed countries and commercial real estate loans. Commercial banks currently hold more consumer loans than commercial loans. Consumer loans rose to almost 27 percent of assets from 18 percent in 1984. On the other hand, commercial loans as a percent of assets declined over the last five years to 25 percent, after remaining fairly constant at 30 percent from 1984 to 1990.

Not all banks that extend credit card and other consumer loans keep the loans in portfolio. A number of institutions securitize and sell their credit card receivables. In September 1991, when we first started collecting data on assets of credit card loans securitized

without recourse through the call report, credit card loans securitized represented nearly 37 percent of credit cards held in portfolio by banks. By March 1996, that percentage had risen to 66 percent. The OCC is monitoring carefully the implications of this rising trend in securitizations.

## Consumer Credit Trends

As discussed in the section above, growth is one factor we evaluate when monitoring lending developments. We also evaluate credit quality, which includes an analysis of trends in loan charge-offs and delinquencies. Several factors work together to mitigate the credit risk posed by commercial banks' shift into consumer lending. Those factors include historically low loss rates on residential real estate loans, the relatively small average loan size for credit card loans, the relatively wide margin obtained on credit card loans, the ability to limit or withdraw credit, a diverse base of borrowers, and an active secondary market for many types of consumer loans. For example, because virtually all banks sell 1-to-4-family mortgage loans into the secondary market, underwriting criteria on those loans are essentially standardized, and delinquencies on home mortgages continue at low rates. In addition, the increase in consumer lending has meant that banks decreased their earlier reliance on certain riskier assets, such as commercial real estate.

One way to review banking industry credit quality is to analyze the net loan loss rates on various loan types. Residential real estate loans, the largest share of consumer sector lending, have the lowest loss rate among consumer loans. Although residential real estate loans have low credit risk, they may present other forms of risk to banks, such as interest rate risk.

Furthermore, as we will discuss later, we remain concerned about consumers' ability to take on additional debt, such as home equity debt, given their high level of debt to disposable income. On the other hand, credit card loans, the smallest share of consumer lending, have the highest credit loss rates. Moreover, loan loss rates for residential real estate and installment loans generally are less volatile than those of credit cards.

Another way to look at credit quality is to examine delinquent loans whose payments are past due 30 or more days plus nonaccrual loans. These delinquent loans may or may not need to be charged off eventually, and so they only provide a rough indication of future losses. The percentage of delinquent consumer loans has risen for several quarters.

Deterioration in credit quality, caused by both cyclical and secular trends, is never good news. Some deterioration in credit at this stage of the business cycle is not unexpected, particularly given the low level from which this indicator is rising. Also, employment growth has slowed and interest rates have risen, putting further pressure on credit quality. Loan loss rates have risen since 1994.

A second factor influencing the recent deterioration in credit quality may be the rise in total debt as a percentage of disposable income. Total debt as a percentage of disposable income is at a relatively high level. People with a higher ratio of debt to income are more likely to fall behind on their debt payments when confronted by a setback, such as the loss of a job. The overall rise in debt since the early 1970s corresponds to the aging of the "baby boom" population cohort. In the early stages of establishing a household, "baby boomers" consumed more and were more willing to increase their level of debt in the process. As the "baby boom" population cohort begins to work its way through the period when saving for retirement becomes predominant, the ratio of debt to disposable income may decrease.

Trends in bankruptcies are also a concern, and may be contributing to the rise in loan defaults. Total bankruptcy filings are estimated to have risen 27 percent, to 318,893, over the four-month period between January 1 and April 26, 1996. This was the largest four-month rate of increase since 1986 and the biggest four month total ever. Some have attributed this rise to the liberalization of the U.S. Bankruptcy Code, which took effect late last year, making Chapter 13 debt reorganization available to more debtors. Previously, consumers with more than $100,000 in unsecured debt and $350,000 in secured debt could seek bankruptcy protection only by liquidating their assets under Chapter 7. Now, consumers with as much as $250,000 in unsecured debt and $750,000 in secured debt may seek reorganization under Chapter 13 rather than liquidation. In addition, even if a debtor elects liquidation under Chapter 7, the Reform Act permits the debtor to retain more of his or her assets than was previously allowed under the Bankruptcy Code.

Others have suggested that the rise in consumer bankruptcies reflects a secular change in consumer attitudes toward debt and responsibility. Such attitudes have changed greatly. In the 19th century, failure to pay debts resulted in debtors' prison. Since 1960, annual bankruptcy filings have increased tenfold, from about 110,000 in 1960 to the million bankruptcies we would observe for 1996 if the pace exhibited in the first four months of 1996 continues. Bankruptcies as well as consumers' willingness to assume debt are much more commonplace today.

Despite these trends, the losses and delinquencies on credit card loans should be considered in the appropriate context. Credit card loans have high net interest margins that reflect, in part, the higher credit risk and proportionately high losses expected of an unsecured credit line. The relatively small number of banks that specialize in credit card lending have successfully managed loan losses in the past, as evidenced by their consistently high profitability. Despite cyclical fluctuations, these banks have been able to price their products to incorporate expected losses, manage credit quality problems through aggressive collection, charge-off and recovery programs, as well as limit or withdraw credit as warranted.

The trends in losses and delinquencies in consumer lending are developments that we as regulators must continue to monitor. We remain concerned, although we do not believe there is a widespread or systemic problem. There are two primary reasons for our concern. First, the high levels of debt today leave consumers and therefore bankers vulnerable to adverse shocks impacting consumers' ability to repay their debts. Second, the high returns associated with credit card loans have lured some bankers into the business without having adequate risk management systems and human capital in place.

## OCC Initiatives

As supervisors, our job is to make sure that banks have sound risk management systems in place, have fundamental structures in place including capital and strong loan loss reserve levels, and that banks are managing risk appropriately. Recent trends suggest that there are some problems with consumer lending that neither regulators nor the banking industry can ignore. Over the past three years, the OCC has taken a number of steps to learn more about developments in consumer credit lending and take appropriate actions to ensure that banks continue to manage risk and operate their businesses profitably.

During my term as Comptroller, our supervisory process has evolved to take into account changes in the banking environment and the banking industry. We monitor developments in the industry to assess risk by gathering information from our database of examination findings, surveys, industry comparisons for nonbank competitors, and reports on the entire banking industry. To respond to that assessment of risk, we educate our examiners through training and revised examination procedures, educate the industry by issuing guidance, and develop regulations as appropriate. We constantly review our examination procedures to ensure that our examiners have up-to-date procedures for assessing bank products and are able to identify and respond to risk. The process is continual, not only because we need to ensure that banks have the necessary risk management processes, but also because the market is constantly developing new products.

Before I provide you with more detail on our actions with respect to consumer credit, I want to stress that as regulators we must continue to insist on safe and sound practices. At the same time we also have a responsibility not to unduly restrict the workings of the market, including the development of innovative lending programs that may ultimately allow more businesses and individuals to participate in the credit process without affecting the safety and soundness of the banking system. We believe our actions reflect these standards.

*Credit Card Horizontal Review.* In 1994, observing the rapid growth in bank credit card operations, the increase in the number of banks specializing in credit card operations, and increased competition among the major issuers, we became concerned that changes in industry underwriting standards could expose banks to increased risk. As a result, we formed a working group to take a closer look at the credit card industry.

During the second half of 1994, OCC examiners reviewed credit card operations at the 15 largest national bank credit card issuers. We learned more about many aspects of credit card operations and in some banks identified several areas where operations could improve. For example, at some banks we recommended a change in the methodology used to determine the allowance for loan and lease losses. We required that some banks analyze and maintain documentation to support the feasibility and effectiveness of policies designed to bring current the accounts of troubled borrowers. For a few banks, we recommended improvements to monitor the impact of procedures of approving lines of credit for borrowers who do not meet their normal lending criteria. In 1995, OCC examiners worked with these banks to ensure they made changes noted to improve their operations.

The results were presented to the examiners and discussed with the banks involved in the survey. We also presented the results of our review to the other bank regulatory agencies and to the Federal Financial Institutions Examination Council (FFIEC) Supervision Task Force in August 1995. Information obtained from this analysis was incorporated into examiner training and the *Comptroller's Handbook* for examiners, as will be discussed below.

*Survey of Automobile Lending.* To learn more about automobile lending underwriting standards, OCC examiners reviewed the underwriting standards of

regional and multinational banks in July 1994. Nearly two-thirds of the examiners surveyed reported no changes in underwriting criteria in the banks over the prior 12 months. However, the survey did point out one trend we want to monitor. Historically, banks based decisions for the amount of automobile loans on the collateral underlying the loan. With the cost of repossession and sale extremely high, the actual benefit to the bank of collateral has decreased. The results of our survey confirmed that auto lending is shifting toward an approach more reliant on a borrower's ability to repay rather than on collateral values. We will continue to monitor trends in automobile lending to assess the impact of this change on portfolio quality. We want to ensure that banks accrue any benefits associated with this change, and we will take action as appropriate if problems develop.

*National Credit Committee.* In February 1995, the OCC created a National Credit Committee. As I stated publicly shortly thereafter, we were concerned about potential erosion in credit underwriting standards, and wanted a group to focus on further analysis of the trend and recommendations for OCC actions. Composed of some of the OCC's most senior and experienced credit analysts, the Committee helps the OCC identify and respond to changes in credit risk that could affect the safety and soundness of the national banking system. The objectives of the Committee are:

- To identify significant concentrations of credit risk affecting the national banking system.

- To identify deteriorating financial trends and other conditions affecting industries that are a significant source of credit risk to the national banking system.

- To identify adverse changes in underwriting standards for loan products that are a significant source of credit risk to the national banking system.

- To advise OCC management on appropriate supervisory responses to significant credit risks.

- To identify the credit-related training needs of examiners.

The Committee acts as a steering committee for credit-related initiatives. To date, the Committee has undertaken two surveys of underwriting standards.

*1995 Underwriting Standards Survey.* Between May 1994 and May 1995, the National Credit Committee surveyed loan underwriting standards, including retail credit, at the 40 largest national banks. The survey results found relaxed standards for making loans on some products, primarily in retail lending. Where standards had relaxed, banks made the changes to meet competitive pressures and to reflect changes in market strategy. The changes in standards we noted included higher loan-to-value ratios, longer maturities, lower loan fees and interest rates, and increased usage of "teaser" rates for marketing purposes. While the surveyed banks had adequate systems to approve and report individual loan policy exceptions, OCC examiners expressed concern about the banks' ability to track the aggregate level of loan policy exceptions. Examiners also reported a wide variation in the systems used to identify and manage risk associated with concentrations of credit, but noted that the systems appeared to be effective. I stated at the time we released our results that I continued to be concerned that banks not lose sight of the effect of new lending on the risk levels in their portfolios. These results and issues identified were communicated to bank management.

*1996 Underwriting Standards Survey.* The National Credit Committee recently concluded its second survey of national banks' underwriting practices. Examiners conducted the survey at 82 of the largest national banks in May 1996. Our preliminary results show that our examiners believe the consumer loan portfolios are experiencing increased inherent risk. The increased risk is attributed to competition, growth, rising bankruptcy rates, and high levels of consumer debt.

The survey's results for lending underwriting standards in the consumer area overall show some bias toward tightening of underwriting standards as compared with last year's survey. But there were some differences. Banks are tightening credit card lending underwriting standards in response to changes in the bankruptcy law, weak portfolio performance with rising delinquencies and charge-offs, and poor product selection. On the other hand, home equity loans are the one retail product where standards continued to ease in response to competitive pressures. The most commonly mentioned change for home equity lending was increased loan-to-value ratios, including greater availability of 100 percent loan-to-value financing. Residential real estate showed no significant change or trend in underwriting standards, while the results for installment lending were mixed, with an equal number of banks surveyed reporting easing as tightening of standards.

These survey results are just in, and I can assure you that as we analyze them further, we will factor the findings into our supervision. For now, let me describe some of the things we are doing based on earlier analyses and findings regarding consumer credit.

*Revised Examination Procedures.* I am committed to making sure that our examination procedures change where necessary to ensure that they are appropriate and effective to meet industry changes. Our surveys and analyses have helped us identify areas for improvement in examination procedures, and we have substantially revised the retail credit sections of the *Comptroller's Handbook*— the examination guide used by national bank examiners. Handbook sections are being brought current in line with the significant market developments and will have a greater focus on risk management. In recognition of the growing importance of mortgage banking to national banks, in April 1996 we issued a new section to the handbook on mortgage banking operations. It discusses the business of mortgage banking, the risks associated with this activity, and the procedures that OCC examiners will use when they review mortgage banking activities at national banks.

We are also working with the other bank regulatory agencies in reviewing and updating policies for consumer credit. In May 1996, we convened an interagency working group to examine the existing interagency policy on the uniform classification of consumer retail credit delinquencies. As part of this effort, the working group is also addressing minimum payment policies.

The OCC will release new *Handbook* sections on installment lending, credit cards, residential and home equity lending, and merchant processing by the end of 1996. Also, as securitizations of financial products continue to expand, the OCC is developing examiner guidance that will focus on risk management of retail credit securitizations. Although most of these *Handbook* sections are being revised, the section on credit cards in particular is being revised substantially to incorporate more detailed guidance to assist examiners in evaluating the effectiveness of a national bank's entire credit card lending process rather than by focussing on loan outcomes — in line with our Supervision by Risk approach. In the traditional approach, examiners analyzed nonperforming loans. Now, they examine the complete lending process.

The examiners pay close attention to changes in trends in delinquencies and net credit losses in determining where to focus supervisory resources in their review of the bank's consumer credit operations. Examiners review a bank's strategic and business plan and the policies and procedures governing retail credit operations, its compliance with OCC guidelines, its response to any criticism by internal or external auditors, its response to any internal loan review or comments made by the OCC in its previous examinations, and its compliance with other laws, rulings, and regulations. They look for changes in credit administration policies and underwriting standards, and sample credit card loans to compare against stated underwriting standards. OCC examiners focus on banks' risk management systems to ensure that the necessary controls exist to identify, including organization and management of marketing, underwriting, process, collections, securitizations, and management information systems.

In addition, the increasing use of credit scoring systems by banks to assist in their decision-making on marketing, granting, and pricing retail credit requires us to incorporate an analysis of these systems into our examination process and training programs. In recognition of the growing technical sophistication of these systems, OCC examiners work with economists with expertise in evaluating the validity of these models.

The OCC is concerned about increased competition in the credit card business, rapid portfolio growth rates, the availability of diverse credit card products, and the impact of changes in the economic and business cycle on national banks' credit card performance. As a result, we are issuing guidance will focus on the problems that have led credit card portfolios to exhibit higher risk profiles than originally projected, including insufficient market testing, adverse selection, liberalized underwriting criteria, and inadequate monitoring of loan performance, and offer potential solutions to these problems.

*Examiner Training.* The OCC has devoted extensive resources over the past three years to broadening examiner skills and knowledge by means of training. Just as we have enhanced our training programs, or developed new ones, in other specialized areas such as capital markets and bank information systems, we are currently drafting a new curriculum for retail credit training in response to the changing nature of this market. We will incorporate these revised procedures into the examiners' Retail Credit School curriculum by year-end 1996. This curriculum pays particular attention to credit cards. In addition to this formal curriculum, we offer periodic credit seminars to our credit specialists. These seminars address current and emerging trends. The last seminar, in June 1996, addressed topics including various risk management functions, electronic banking, credit bureau scoring and accuracy of credit bureau reports, collection strategies, and securitizations.

*National Risk Expert.* The OCC recently created a new position for a national risk expert. I named National Bank Examiner G. Scott Calhoun to serve in this role. As the Deputy Comptroller for Risk Evaluation, Mr. Calhoun will be my principal advisor on risks facing the national banking system. Drawing on nearly 20 years of experience with the OCC, including serving as the

examiner-in-charge of several of the nation's largest banks, Mr. Calhoun will help the OCC identify risks in national banks, assist in developing timely supervisory responses, and monitor them to ensure that supervisory responses are effective. He will also chair the OCC's National Risk Committee, which is charged with identifying potentially serious risks to the banking system.

*Planned Initiatives.* As part of our efforts to remain at the forefront of bank supervision, we must continue to monitor and be at the forefront of understanding developments in consumer lending. This includes learning more about issues associated with special purpose credit card-only banks, outsourcing, risk-based pricing and subprime lending. Based on what we learn, we will issue appropriate examiner and industry guidance. In addition, we plan to focus particular attention on evolving developments in underwriting standards for small business lending and the use of credit cards in extending small business loans, and determine the extent of activity in automobile dealer floor plan financing and indirect automobile lending to consumers.

## Conclusion

Commercial banks have moved increasingly into consumer sector lending over the last 10 years. The largest and fastest growing sector is residential real estate lending, which historically has had lower loan loss rates than other types of lending. Commercial banks have experienced some deterioration in consumer sector credit quality in recent quarters, particularly in installment and credit card loans. Although there is no evidence of systemic consumer credit quality problems in the banking system at this time, we remain concerned about trends in credit quality, particularly given the rise in consumer debt and bankruptcies. We will continue to be vigilant and proactive, and make this area a priority for analysis, training, and other appropriate actions.

A regulator's job is to ask questions — even when it appears that everything is going well. How will today's asset and liability management strategies weather economic changes? And how will banks' new sources of revenue be affected if interest rates change or the economy weakens? Although a great deal has changed in banking, some things have not — particularly the need to focus on the fundamentals of sound risk management. I have mentioned today some of the steps the OCC has taken as the banking industry has shifted larger portions of its portfolio to consumer lending. We will continue to develop and refine supervisory initiatives in order to maintain the safety and soundness of the national banking system.

# Remarks by Eugene A. Ludwig, Comptroller of the Currency, before the Dedication of the Operation Hope Banking Center, on community development, Los Angeles, California, September 5, 1996

More than a hundred years ago, the poet Robert Browning wrote that mankind's reach should exceed its grasp. That simple, eloquent thought captures an important aspect of America's greatness. The reach that exceeds our grasp challenges us to new heights. The determination to go beyond what seems possible fuels countless entrepreneurs and growing ventures. Our restless desire to continually create something new, something better, makes our economy thrive and propels our nation and our society forward.

In short, it is that reach — when combined with energy and opportunity —that has caused so many American Dreams to become realities. This nation, its cities, its forms of government and commerce all stand as legacies to the fact that where hope, energy, and opportunity reside, great things can be accomplished.

But as we all know, hope and opportunity are too often scarce resources in many American inner cities. We have all seen the forgotten neighborhoods. We all know that our alabaster cities are too often dimmed by human tears. Many of us have walked the abandoned streets of blighted communities. There is a tragedy about such places. A tragedy because we as a nation have allowed dreams to be denied and opportunities to be extinguished. No nation can prosper — indeed no nation can be long secure — when any citizen or any part of a community is effectively denied the real chance of a decent future. America — built as it is on great dreams, great promise, and the greatness that come from reaching beyond its grasp — cannot deny any one or any community the opportunity to create a decent life and a better future.

We must work together to change this and restore hope in these communities. Fortunately, the work of restoration has begun. There are, today, Americans and American institutions making the reach to create a more hopeful nation ... leaders who not only care, but who are prepared to act. These men and women have rolled up their sleeves and invested a great deal of sweat equity to provide their fellow citizens with a meaningful piece of the American dream.

We are here today with some of those leaders: John Bryant, the men and women of Operation Hope and the community and business leaders who share their vision. In my book, you are genuine American heroes — local heroes — for what you are doing to offer renewed hope, energy, and opportunity for the city of Los Angeles.

As Comptroller, I also have to say that I take pride in what the Office of the Comptroller of the Currency (OCC), its people and the national banks we supervise have been doing to lead in this important area. I know there are those who feel that bureaucrats and bankers do not always do enough, and certainly, there is a lot more work for us to do. But I think it is useful to focus some attention on what has been accomplished since the first time I visited Los Angeles as a public servant.

In the last three years, we have seen a dramatic increase in lending and investments by banks to low- and moderate-income areas. I think the most dramatic evidence of the progress we've witnessed is found in the Home Mortgage Disclosure Act (HMDA) data. Between 1993 and 1994 alone, there was a 27 percent increase in conventional home purchase loans to low-income households nationwide. Loans to African-American families around the country rose 55 percent, and mortgages to Hispanic families jumped 42 percent during those years — that is particularly striking at a time when the market as a whole was growing at about 18 percent. Most recent data show that this improvement continued through 1995 for African-American and Hispanic mortgage applicants.

The numbers for Los Angeles also speak volumes. Since 1992, $20 billion of home purchase loans were made to minority families in the greater Los Angeles area. I am proud to say that our national banks in this area contributed significantly to that success by increasing mortgage lending to Hispanic borrowers nearly 200 percent during that time period. Further, home mortgage lending to area African-Americans — by all financial institutions— has increased 85 percent since 1992 — nearly three times the rate of the market as a whole.

Moreover, it is important to note that in the last three years the annual rate of home mortgage lending to low- and moderate-income families in Los Angeles has more than doubled. Put another way, the increased rate of home mortgage lending to low- and moderate-income families in Los Angeles since 1993 has meant that there are 12,200 families in homes today throughout this city that would not have been without this increased level of bank activity.

In addition to improved HMDA results, national bank investments in community development corporations and CDC projects has quadrupled in less than four

years. Here in California, national banks have contributed to and leveraged over $1 billion in community development and public welfare investment since 1992. And when we look to the future, we have seen a huge increase in loan commitments. For example, in the last three years the commitment has been $100 billion. This figure represents 70 percent of all commitments made since CRA was enacted in 1997.

These are impressive, important numbers, and all of us who are concerned about the fate of our children and the future of our cities can take pride in the progress these statistics represent. I applaud the commitment the banking industry has made to reach beyond its grasp to serve previously underserved communities and families.

When I became Comptroller of the Currency in April 1993, I set four priorities for the Office to pursue, one of which was to work closely with the industry and community leaders to ensure that all creditworthy Americans had fair and equal access to credit. Achieving that objective has required work on a number of fronts.

At President Clinton's direction, the OCC led a two-year effort to revise the Community Reinvestment Act (CRA) rule and shift the emphasis from process and paperwork to focusing more on bank performance. Through an open administrative process that included six public hearings across the country, including meetings here in Los Angeles, testimony from more than 300 witnesses and 7,000 comment letters from bankers and community groups, the goal was achieved — a new CRA regulation that is proving more effective in meeting community credit needs while significantly reducing burdens for banks.

Among the new directions taken by the reformed CRA is an increased focus on banking services as an adjunct to credit. The new CRA service test offers greater opportunities for banks — directly or in partnership with community groups such as Operation Hope — to provide broad-based community development services.

For example, under today's CRA, banks receive service credit for activities such as lending executives to affordable housing organizations, offering school savings programs, making grants to foundations that teach at-risk youths entrepreneurial business skills, or providing technical expertise to nonprofit organizations devoted to health services. This is a tribute to the fact that keeping a community economically vibrant requires a variety of approaches.

In addition to our drive to revise CRA and make it a more comprehensive vehicle for community reinvestment, in April 1993, the OCC shifted the focus of our fair lending examination procedures away from comparing loan files with bank lending policy to determining — through comparative file analysis — whether a bank's home loan application process produces similar outcomes for minority and nonminority applicants with similar qualifications.

Since that change, we have conducted over 3,000 fair lending examinations. We have made 23 referrals and notifications to the Department of Justice and the Department of Housing and Urban Development of violations of fair lending laws. In the previous history of fair lending laws — a quarter of a century — the OCC had made but a single referral. And that referral was inspired, not because of an examination, but as the result of an advertisement.

While there may remain incidents like these that require our diligence, today, we see a changing picture. From a national perspective, bankers are making aggressive, progressive strides to expand their markets and serve their communities responsibly. And the OCC is working with them, because beyond our supervisory responsibilities, we have an important role to play as a resource by offering community development expertise and providing forums for discussion and information sharing.

To increase the OCC's support for the industry's community development initiatives, we now have community development specialists in each of our district offices. These specialists serve as a resource for bankers and their community partners as they strive to implement profitable community development lending and investment programs. Our OCC staff has conducted over 200 specific outreach meetings across the country to seek ways the OCC can better serve community development and consumer groups, and I meet monthly with consumer, small business, and community development professionals. Incidentally, I'll be leaving here in a few minutes to attend an OCC luncheon with community development specialists from throughout Southern California. And earlier this year, we hosted a conference in Washington that brought together bankers and community leaders from across the United States to talk about the profitable market opportunities community development lending represents.

In addition to face-to-face communications, the OCC is employing information technology to share knowledge and advance community development activity. We have brought more CRA material to the World Wide Web than any other agency or organization. I encourage you to visit our Web site at www.occ.treas.gov. This link gives bankers and community development

experts access to our latest legal interpretations relating to CRA, so they can get a clear sense of the unique, creative ways institutions are meeting their CRA obligations. Further, the Web site offers users the opportunity to download the latest CRA evaluations, allowing interested groups and individuals to search by institution or by state to see when banks in their community have been assessed and how well they performed.

That is what we are doing in Washington and throughout the OCC to improve the way we supervise banks and communicate with the banking industry and the public. But it is out here — in the trenches and through yeoman efforts by business, local government, and concerned citizens — where the really exciting work is being done.

On our bus tour today, we have seen what greater cooperation at the local level can yield. What a difference a few years make! The buses that took us through the surrounding neighborhood passed by sights that I would not have believed possible three short years ago when I last visited this area. From our bus windows in the fall of 1993 we saw scores of problems left in the wake of rioting that opened wounds some thought could never be healed. It was a sobering tour, and the challenges before this city and its leaders were obvious and unenviable. The challenges were such that I would think that even an energetic optimist like John Bryant had to have been asking himself, "Is there really any hope here?"

But hope was there . . . hope that gave rise to solutions . . . hope that attracted over a billion dollars of corporate investment to an inner city that citizens and businesses were determined to rebuild. . . hope that brings the $1 million dollars of Small Business Administration Loans for minority-owned businesses, which we presented today. On this bus trip through South Central, yes, we still felt the weight of all there is to be done, and, yes, we recognized that we are by no means at the promised land. But we were also able to clap our hands and celebrate the results of your shared commitment to South Central's future. Hope is indeed here today.

We should take the time to pat ourselves on the back and think about how far we have come in community development. It is deserved. But we must not break our arms in the process, because we still have hard work to do, and we must now set our sights on the tasks ahead. Today, it is clear to all of us who care about revitalization in places like South Central Los Angeles that continued progress depends upon strong local partnerships and continuous process improvement — partnerships focusing on the nuts and bolts of mortgage lending and community development. I am talking about the day-to-day attention to the fundamentals — refining and perfecting, for example, the process by which the banking industry underwrites loans and services the obligation throughout the life of the loan . . . the process of managing properties and providing families and businesses effective counseling . . . the process of strengthening existing partnerships, adapting to changing realities, and embracing new cooperative strategies. All of this is necessary to move the community development market fully into the mainstream and help today's new customers establish relationships with their financial services providers that can last a lifetime.

That is what makes this new banking center so exciting. It brings two of the concepts shaping the future of financial services everywhere — relationship banking and technology — into the inner city. The Operation Hope Banking Center can be a model for how to reach out to underserved communities and put the benefits of technological advances within their grasp. John Bryant, Operation Hope, and the dozens of financial institutions involved in this undertaking are pioneers who share a strong commitment to ensure that access to financial services is preserved in an era of banking industry consolidation and electronic commerce. You have created a high-tech, one-stop shop for financial services, where men and women can come to do everything from paying utility bills to receiving credit counseling, to exploring entrepreneurial franchise opportunities.

A center like this demonstrates that the inner city need not be swept away by the currents of change running through the financial services industry. Rather, these forces can provide expanded opportunity and hope to those who already have relationships with banks as well as to the thousands of unbanked individuals who are not currently served by the banking industry. In recent years, we have devoted considerable energies to reaching out to banking's underserved. The next frontier for all of us will be to find ways to reach the unserved — those who have no relationship with a financial institution, no way of building a solid credit history, no place to cash a check without incurring an expense, no help in preparing for their future. We can and must bring them into a banking system that is continually evolving and increasingly capable of finding new ways to serve all of our citizens better. It is within our reach. Doing that will be a challenge, of course. But we not only have the responsibility to do so, we have a base to build on. We have shown that it is possible to dramatically increase financial services business in low- and moderate-income areas. We have seen banks do this business— not as a handout, a charity, or an obligation — but as a real profit-making endeavor. We have seen that dedication, energy, and partnerships among dedicated citizens like John Bryant, bankers and public servants

do, indeed, make a difference. We have seen that there are reasons to hope — that we Americans will never stop reaching beyond our grasp.

# Remarks by Eugene A. Ludwig, Comptroller of the Currency, before the Detroit Economic Development Tour, on community development, Detroit, Michigan, September 17, 1996

Today, we have had the opportunity to see first-hand how Detroit's empowerment zone and its financial institutions are revitalizing this historic city and offering new opportunities for your citizens and communities. Everyone who calls Detroit home can be proud of the efforts that are underway in places like Parkside Homes and Virginia Park. It has been an absolute delight to talk to new urban homeowners and hear how excited they are to see their dream of homeownership become a reality . . . to learn about the homeownership counseling services that the Church of the Messiah is making available . . . and now to help open this renovated warehouse space for Detroit Discount Distributors, which is bringing jobs, excitement and — I'm sure — great food to the people of Detroit.

We saw on this tour both the possibilities and the challenges. Much work remains to be done, but we now know how it must be addressed. We must work together in strong public-private partnerships — bankers, government, community groups, business owners, residents, and community leaders — to revitalize neighborhoods and make Detroit's renaissance real for all of its citizens. I know that the members of the zone's banking consortium have the same sense of pride a new homeowner feels. They have the thrill of accomplishment that comes when tough problems are tackled in partnership with others who share a common hope. It is a tribute to the members of this consortium — Michigan National Bank, First Federal of Michigan, First of America, First Independence National Bank of Detroit, Comerica, the First Nationwide, and Standard Federal — that of all designated empowerment zones, Detroit has the most active formal participation of private banks and thrift than any other designated empowerment zone. Your stellar consortium has made a $1 billion commitment to lend in the Detroit empowerment zone over the next 10 years. Your commitment means you are bringing $100 million annually to this area — an investment that will reap untold benefits for the 100,000 citizens who live here and the 9,000 businesses that serve them.

As Comptroller, I also have to say that I take pride in what the Office of the Comptroller of the Currency (OCC), its people and the national banks we supervise have been doing to lead in this important area. In the last three years, we have seen a dramatic increase in lending and investments by banks to low- and moderate-income areas and areas designated by government for redevelopment. Here in Michigan, home purchase loans to minority households increased 125 percent from 1992 to 1995 — more than double the rate for the market as a whole. The number of loans made in the state's low- and moderate-income census tracts also outpaced the rest of the market by a similar rate. These figures demonstrate the progress made in ensuring fair lending and eliminating discriminatory practices from credit decisions.

In addition, since 1993, national banks and their community partners have made over $3 billion of investments in community development corporations and CD projects across the country. This money is geared primarily to providing housing, services, and jobs for low and moderate income people and to provide equity and special debt for small businesses. And when we look to the future, we have seen a huge increase in loan commitments. For example, in the last three years the commitment has been $100 billion. This figure represents 70 percent of all commitments made since the Community Reinvestment Act was enacted in 1979.

When I became Comptroller of the Currency in April 1993, I set four priorities for the Office to pursue, one of which was to work closely with the industry and community leaders to ensure that all creditworthy Americans had fair and equal access to credit. Our work has taken many forms, from revising the Community Reinvestment Act rule to make it more effective and less burdensome, to improving the quality and quantity of our fair lending examinations, to hiring community development specialists — assigned to each of our OCC district offices — to work with the industry and community leaders to foster greater cooperation and results. Earlier this year, we hosted a conference in Washington to focus attention on the profitable business opportunities that community redevelopment represents for all of us. And as we prepare to cut the ribbon on this sparkling facility, I should also note that the new CRA's emphasis on small business lending — along with its support of Small Business Administration programs — encourages the type of investment we see here this morning and is an example of how sensible regulation can help stimulate community redevelopment in Detroit and throughout the United States.

Today, I am pleased to announce another step we are taking to support banks and their communities. Today, we are making it easier for national banks to use their community development investment authority to help improve the quality of life in economically distressed

neighborhoods. We have submitted for publication to the Federal Register our revised Community Development Investment regulation. Part 24, as the rule is called, is the OCC's regulation governing national banks' investments designated primarily to promote the public welfare. The revision to part 24 will enhance banks' authority to make investments in the public welfare, promote partnerships between banks and the communities they serve and reduce burden on banks.

The cornerstone of part 24 is the requirement that all investments made under this rule benefit low- and moderate-income individuals, low- and moderate-income areas, or areas that have been designated for redevelopment by local, tribal, state or federal government. Part 24 expressly authorizes investments in Federal Enterprise Communities and Federal Empowerment Zones. By doing this, the OCC sends a strong signal to the over 2,800 banks we supervise that targeted redevelopment is good policy and good business.

We hope to see even more of the innovative approaches already being developed and put in place in empowerment zones and empowerment communities throughout the midwest and across the country. First National Bank of Chicago, for example, has a $100,000 pilot program to provide downpayment grants of up to $1,500 to qualified homebuyers in their city's empowerment zone. This initiative — part of the bank's $240 million commitment to lend to consumers and businesses in the Chicago empowerment zone, will make it possible for between 75 and 100 families to buy a house. Along the shores of another Great Lake, eight banks in Cleveland are working with the Small Business Administration to promote small business lending in Cleveland's empowerment zone. Down the road from Cleveland, five banks in Akron have each offered $1 million to promote the SBA's low-doc loan program and provide financing to over 90 businesses in that city's empowerment community this first year alone. And in Wilmington, Delaware's empowerment community, businesses located in that designated area or those companies that hire residents of the empowerment community can receive below-market-rate loans made possible by a new tax-exempt bond financing program a local bank is underwriting. The revised part 24 will give others greater incentive to follow these kind of leads.

While we have made part 24 more flexible for banks, we have also retained a component that we believe is absolutely vital — the requirement for community support for and participation in bank community development investments. The rule encourages a variety of community partnerships such as:

- Community representation on community development corporation boards of directors.
- The establishment of community advisory boards for banks' community development activities.
- The formation of formal business relationships with community-based organizations.

I want to stress that part 24 is not just another bureaucratic maze that we are requiring banks to negotiate or paperwork that produces eye-strain, headaches and frustration for all involved. No, the OCC listens when banks and community groups tell us they need simplified, streamlined rules. When published, the text of the rule will occupy less than three pages in the Federal Register.

In those three pages, we have provided banks two very clear options for dealing with our agency. The first option, available for most banks and most investments, is called "self-certification," which we have allowed for the past two years, but are now expanding this concept even more. Self-certification eliminates the time-consuming application processes banks had previously confronted. The new streamlined process permits a bank to work closely — and with flexibility — with its community partners, making direct commitments to structure needed financing for affordable housing, small business loans, micro-enterprise lending and many other critical activities that are essential to underserved communities. The bank is required to simply notify us 10 days after making the investment, describing the investment and certifying that it complies with the requirements we've set forth.

The second option applies to banks and investments that are not eligible for self-certifications. Under this process, a bank need only submit to the OCC a letter — much like the one used for self-certification — prior to making an investment. Unless notified otherwise by the OCC within 30 days, the bank may proceed with the investment.

These simple regulatory options reflect my belief that banks and their community partners are in the best position to determine what approaches make best sense for the places in which they live, work, and do business. We are going to make sure that part 24 is part of the solution in communities like the ones we visited today.

I am confident that the type of reinvestment and revitalization we saw today and celebrate with this ribbon-cutting will continue to make cities like Detroit better places to raise a family and realize the American

Dream of continued achievement. You are achieving great things here in this empowerment zone — here and throughout the metropolitan community. Your efforts, while never easy and never without struggle, are crucial to this city's and this country's future. And with each success — with each new home, new business opened and new job created — you are demonstrating that people who care and come together can make a profound difference.

# Remarks by Eugene A. Ludwig, Comptroller of the Currency, before the 1996 OCC Managers' Conference, on the OCC's mission, objectives, and accomplishments, Detroit, Michigan, September 17, 1996

How often does this happen to you? You meet someone — perhaps on a plane flying to Detroit — who asks you a simple, innocuous question, "Where do you work?" or "What do you do?"

Smiling politely, you say, "The Office of the Comptroller of the Currency," knowing that although the person may have heard of the office or seen a reference to us in the local newspaper, unless the person is a banker, businessperson, or fellow regulator, he or she probably has very little sense of what a unique agency the Comptroller's Office is or the vast contributions we have made to the nation's financial services history and its economic progress.

Call it a Comptroller pride thing, but when I get asked a question like that, I can't wait to launch into the answer.

No, our agency is not well-known, but our mark can be found throughout the history books. So much so, that the average citizen of an earlier time would have known a great deal more about our origins and our importance. The OCC:

- Was created by President Lincoln because of his belief in the importance of a strong national banking system.

- Helped shape the direction of American finance in the 20th century.

- Has been staffed and led by exceptional people of integrity, vision, and influence.

Our history is indeed rich and long — and, of course, we have had our share of ups and downs. It is no secret that the late 1980s and early 1990s were difficult times for banking and bank supervisors.

But we have rebounded. Today, because of you and your collective ability to rise to the challenge, the OCC is stronger than it ever has been and — because of you — a national bank charter has never meant more. And the OCC story is one we can tell with increasing pride.

- Conversions are going our way. Between 1986 had 1994, we had net conversions from national to state charters of -99 banks. This trend started to reverse in 1995 and the trend continues to the present with net conversions of +21 banks.

- Assets are flowing into the national banking system. We are seeing national bank assets continue to increase whereas state bank assets have leveled off since 1995. An even more noticeable change is in national bank share of industry assets, which increased significantly in 1995 after declining for several years.

- And the national banking system is strong. Capital levels continue to increase.

So, while the OCC might never be a household name, our impact is felt in millions of households . . . our reputation as an agency on the cutting edge of financial services supervision is secure. Our four pillar program is working for us today and preparing ourselves and the banking industry for a future as vibrant as the past.

The story I want to share with you this morning is our story, the OCC story — one that everyone who works for this office should take credit for and pride in. Although I want to recognize the contributions of Executive Committee members for leading efforts of particular significance, that in no way should diminish the fact that our accomplishments depend on hundreds of OCC men and women striving toward the shared goals of our four pillars program. I would now like to introduce the two newest members of the Executive Committee: Matt Roberts and Jim Kamihachi.

## Four Pillars Accomplishments

Our goal: Making bank supervision more relevant to the realities of today's banking environment.

### *Safety and Soundness*

- Supervision by risk. Led by Senior Deputy Comptroller for Bank Supervision Policy Susan Krause. Thomas Ripke, chairman of Robert Morris Associates, has observed that "Supervision by risk is a holistic approach to the subject of risk management. It gives you a far more forward-looking picture of what all of your risks are."

- National Credit Committee Development.

- International cooperation. Developing voluntary standards of practice.

*Competitiveness*

- Litigation record. Led by Chief Counsel Julie Williams. Four consecutive times in the last two years the Supreme Court has unanimously agreed (in an unprecedented 9 to 0 vote) with the agency's interpretation of the National Bank Act and our ability to apply it to contemporary financial services. Our record to date has been 50 wins and 9 losses (none of which were at the Supreme Court level.)

*Efficiency/Burden Reduction*

- Led by Senior Deputy Comptroller for Bank Supervision Operations Leann Britton (previously led by Steve Steinbrink).

- Simplified examination procedures for noncomplex banks.

- Regulatory Review Project. Led by Chief Counsel Julie Williams. Since mid-1993, we have been reviewing our regulations from A to Z.

- Application processing is more efficient. We eliminated the need for one-half of all bank applications and implemented fast track process for others.

- Assets per examiner on the rise, which reflects our increasing supervision efficiency. Participation by economists has helped improve efficiency.

- We have a more experienced examiner staff compared to 1990; average experience increased from 9.7 years to 12.5 years.

- Interdisciplinary approach to supervision. Led by Senior Deputy Comptroller for Economic Analysis Jim Kamihachi.

- Outreach. Led by Ombudsman Sam Golden. Bankers' responses to exam survey were very favorable with regards to OCC's communication skills, professionalism, adding value, and reducing burden. Bankers tell me time and time again in outreach meetings that their exams have been the best in over 40 years. Responses were also positive on BOS survey.

- Fee reductions. Led by Senior Deputy Comptroller for Administration Judy Walter. We have seen $68MM annual savings in fee reductions to the national banking system.

*Expanding Access to Credit and Other Financial Services*

- Led by former Senior Deputy Comptroller Konrad Alt.

- CRA reform. HMDA results showed a significant increase in home purchase loans between 1992 and 1995 to low- and moderate-income persons and loans to minorities. CRA reform has been applauded by bankers.

- Introduction of Community Development Specialists.

- Industry commitments. In the last three years, $100 billion in industry commitments have been made, compared to $41 billion for the previous 16 years since CRA was enacted.

We have taken some tough steps, together, and although we have not always agreed on everything we have tried to do, the end result is this: Because of our combined efforts, the OCC is more capable of providing the supervision the industry needs. In short, the OCC is today a more progressive regulatory agency — making necessary changes and laying the groundwork to meet our mission into the next century.

Now, of course, no one knows exactly what the future holds for banking and bank supervision. Some have even speculated that in the years to come there won't even be banks for us or our sons and daughters to regulate. We have all heard the words "dinosaurs" and "banks" mentioned in the same sentence often enough to know that the future holds no sure things and no promises for anyone.

I will not make any promises either, but I will offer some best guesses.

My bet is that banks are not going away and are nowhere near extinction. But it is a sure bet that tomorrow's banks will look different from the banks we have traditionally supervised for much of the agency's history and that they will not always be in the same towns, cities, and states they are today. And I would also hazard a guess that tomorrow's national banks will — as they have been ever since Lincoln's era — lead players in the country's economic development and the financial services industry.

I can make that educated guess because I know you. And you know that the question of whether banks will

be significant factors for decades to come is dependent — in very large measure — on our ability to be forward looking and capable of effectively supervising an ever-evolving, increasingly complex, and technologically sophisticated banking system.

That means the career paths we must follow today, and that future OCC employees will follow tomorrow, must lead to where we are as good as — or better than — the banks under our supervision in dealing with change, identifying and measuring complex risks, and employing technological tools. That path requires us to be multidisciplinary, better prepared, and more sophisticated. That path leads to jobs that are rewarding, always in demand, and truly capable of creating significant value for the national banking system.

A regulatory agency that does not face up to the challenge of change and continually re-tool will soon become irrelevant. And the need to change is being driven not by any one person or committee within the OCC but by external factors and the sea change that enhanced competition, technology, industry consolidation, and globalization represent.

To remain successful, the OCC must approach the future with the same type of attitude that our country's most visionary banks have adopted. As I go around the country talking to bankers, I am sure I see the same thing you do during the course of examining their banks — that some institutions are clearly better prepared for the future than others. My hope is that when bankers look to the regulatory community, they see in us an agency better prepared for the future than our peers at the federal and state levels.

That is the key to being the agency banks want to have supervising them — now, and for years to come. But let me be clear about what that statement does *not* mean. It does not mean we can ever compromise the quality of our supervision or our integrity. It has never been our role to be simply cheerleaders for the industry. Our role is quite clear, and it is found in our mission statement:

> The OCC charters, regulates and supervises national banks to ensure a safe, sound and competitive national banking system that supports the citizens, communities and economy of the United States.

The words of that mission statement also remind us that neither banks nor the OCC can neglect the concerns of consumers or turn our backs on ordinary people. Balancing the sometimes competing demands of industry and public can be difficult at times, but it is a balance we must strike true — it is a legal requirement, a business necessity, and a responsibility that both the public and the politicians will hold us to. That also underscores why it is essential that we be public relations conscious and effective in communicating our performance and our public policy positions in the halls of Congress and to industry trade groups.

We want the person on the plane to know what the OCC is all about and we need the policymaker in Washington to see us as an insightful and visionary player in the financial services debate. We have, I believe, elevated our stature in recent years, and even those who may disagree with us on the issues would not deny that we bring considerable intellect and professionalism to the task of shaping the future of banking and financial services.

If we make a commitment to embrace change and develop the skills and relationships we must, the OCC will stay at the forefront of bank supervision, and our national banks will be leaders in the financial services industry of the 21st century.

But I do not want to sugarcoat the challenge before us or paint a Pollyannaish picture that does not match the realities we all know exist. Change is hard. There will be discomfort and stress as we strive to distinguish ourselves vis a vis other federal and state regulators to be the regulator of choice within the industry. In many ways, the task before us is even more difficult because we start a little behind and are the higher cost provider of supervision. But we can be competitive on cost and we will win on value. I have never read any articles in the *Wall Street Journal* accusing us of being a wasteful, inefficient regulatory agency, and I know I never will.

The story I want to read and tell — and the one you are creating — is of the premier regulatory agency staffed with superior people and armed with the skills, experience, and perspectives the industry truly values.

The objectives for 1997 that you have helped us develop point the OCC in the direction we must go to reach that vision of our future. During the next two days, we will have the opportunity to discuss these seven strategic objectives in more detail, and I know Senior Deputy Comptroller Leann Britton has a lot more to say about how these objectives were reached and why they are the right ones for the coming year.

Next year, the agency's primary objectives are:

- Supervision by risk: Build on progress to date.
- Technology to support our workforce: Implement an integrated information technology plan.

- Workforce skills, abilities, and resources: Manage the evolution of the workforce.

- Effectiveness measures for OCC programs, processes, and projects: Ensure that we are achieving intended results.

- Internal communications: Develop a coordinated and integrated process of communicating within OCC.

- Electronic money and banking: Develop a timely and appropriate response to the introduction of E-money/E-banking.

- Access to financial services: Invigorate and better institutionalize the OCC's efforts to improve access.

Again, thank you for your commitment and dedication to the OCC's important mission ... thank you for the hard work you have done to make the OCC all it has come to stand for, and the hard work I know you're doing to make it what it will become in the years ahead.

Call it a Comptroller pride thing, but I am confident that the OCC story will continue to grow and prosper along with the national banking system.

# Remarks by Leann Britton, Senior Deputy Comptroller for Bank Supervision Operations, before the OCC Managers' Conference, on OCC objectives for 1997, Detroit, Michigan, September 17, 1996

You have just heard Comptroller Gene Ludwig talk about our many accomplishments over the past few years. We have made tremendous progress on a number of fronts — implementation of our Supervision by Risk approach; the review and streamlining of all our regulations; expansion of bank powers; a streamlined corporate application process; and through your efforts as managers — the development of a workforce that is recognized as the most capable and professional among the regulatory agencies. As Gene said, you are the people who made these accomplishments possible. And you should be proud of all you have accomplished.

But we cannot rest on our past achievements. You have also heard Comptroller Ludwig describe the massive changes that are occurring in the banking industry as we enter the next century. And his vision of the agency we must become in order to stay at the forefront of bank supervision. Over the past several months, the Comptroller and the Executive Committee have spent a considerable amount of time thinking about, and discussing, the actions we must take to make that vision a reality. We have developed a game plan — our 1997 objectives — that we believe will take us several steps down the road toward accomplishing that.

On behalf of the Executive Committee, I would like to talk to you about those objectives and some of the specific actions we plan to take to accomplish them. It is important that all of you understand and support the objectives, and — as leaders of this agency — leave this conference committed to ensuring that your staff understands and supports the objectives as well.

But before I do that, I would like to take a step back and explain to you how this game plan — these objectives and the underlying action plan — were developed. I think this is key to your knowing that these are not just the Comptroller's objectives for the agency, nor are they the Executive Committee's objectives — they are yours as well. In setting these objectives, the Comptroller and Executive Committee recognized the value that could be gained by enlisting the brainpower and perspectives of the OCC's entire workforce in helping us focus on the issues most critical to the OCC's success.

In order to do so, we decided to hold focus group sessions with employees and managers throughout the agency. The goal of the focus group sessions was quite simple: To bring senior management and employees together for the purpose of discussing the agency's priorities — the four pillars. And use the sessions as an opportunity for management to get employee input on the actions that were most critical in helping us achieve those priorities.

Executive Committee members conducted 21 focus group meetings with approximately 200 employees and managers participating. Participants in these sessions identified five key issues that they felt we needed to focus on in 1997:

1) Maintain an experienced workforce, and as a part of that strengthen training on emerging risks and new products and for our precommissioned examiners.

2) Continue to implement the OCC's supervision by risk approach.

3) Address employee morale issues resulting from rightsizing.

4) Improve information flow to the field and to bankers and across functions.

5) Continue to promote expanded powers for banks.

The focus group sessions clearly met their goal of providing the Executive Committee with valuable input for the agency's objectives. This feedback is directly incorporated into the 1997 objectives we will be discussing. However, the sessions also resulted in a couple of very important side benefits as well: They enabled each of us to broaden our understanding of issues and concerns outside our own area of responsibility. As an example, I think all Executive Committee members gained a much better appreciation for the impact our rightsizing initiative was having on employee morale.

Our employees have always been what makes the OCC the great organization it is. Steve Steinbrink said it well at last year's conference when he said our employees are the "heart and soul" of this organization. We all understand intellectually that a rightsizing initiative is necessary to match our staff levels with the reduced workload caused by industry consolidation. But the effect that our rightsizing efforts was having on our workforce became much more real when Executive Committee members heard firsthand from you what it

is like to sit across the desk from some of your best employees and tell them that we just do not have the work to support their positions any more.

We also received a lot of positive feedback on the work being done in the agency to promote bank powers. It was clear that employees throughout the agency appreciated the hard work that the Comptroller, Julie Williams and her legal staff, Konrad Alt and his public affairs staff, and Jim Kamihachi and his economics staff were doing in this area. And although this may sound a little corney, it was also clear the employees took quite a bit of pride in reading those front page articles announcing our various victories in the courts and on the Hill.

The focus group sessions also provided us with valuable input on the effectiveness of our internal communication processes. A perception that surfaced in several of the sessions was that as an agency we did not have a well-defined direction or vision for where we needed to go. However, we all knew that the Comptroller had set a very clear course for the agency. He had articulated in the "four pillars" the areas he believed we must focus on. And he had communicated them on numerous occasions — at last year's conference, in nearly every speech he gives, and at nearly every OCC meeting he attends. Despite that, we found that many employees did not recognize the pillars as providing the framework and direction for the OCC's activities. We hope to address this issue as part of this conference.

But let's get back to the 1997 Objectives. Yesterday, you received the draft objectives. That document outlines specific actions we plan to take to achieve the objectives the Comptroller has described. You may want to refer to that handout as I highlight some of the objectives we will be focusing on in 1997.

I would like to begin with the Supervision by Risk objective — because that most directly impacts our core business of bank supervision. We strongly believe that Supervision by Risk is the correct supervisory philosophy for us to use. It provides us the flexibility to respond to the rapid changes occurring in the banking industry. And it insures that in the midst of all these changes, we are allocating our resources to the areas in individual banks and the industry as a whole that pose the greatest risk. Over the next year, we plan to build on the progress we have made so far in integrating this philosophy into our operations.

As a part of this, we will be focusing attention on several areas.

First we will be working to make sure that all of our banker and examiner guidance reflects and supports our supervision by risk philosophy. And we will be investigating alternative delivery systems for our banker and examiner guidance that take advantage of the technology available. We will also be working to make sure all employees are equipped with an easily accessible, integrated, and current reference system to support their supervision-related activities.

Our goal is that maybe — in the future — rather than spending your evenings and weekends trying to maintain a hard-copy filing system of our various policy issuances, you'll be able to simply log-on to the Internet or Intranet, and pull down the most current issuances and guidance off of the OCC's Home-Page.

To date, we have focused most of our attention on integrating a risk-based philosophy into our safety and soundness activities. During 1997, we will be working to integrate the supervision by risk philosophy into our BIS, fiduciary, and consumer compliance policies and activities as well.

We will also be taking a hard look at how we approach our community bank supervision responsibilities. In keeping with our supervision by risk philosophy, we want to ensure that the resources we are allocating to our community banks are commensurate with the risks they pose to the overall national banking system. Obviously, revenue constraints are also driving us to find more efficient means of supervising our community bank population. But as we look toward finding more efficient ways to supervise community banks, I am convinced that does not mean we provide them with poorer quality supervision.

Instead we need to explore the efficiencies that can be gained by utilizing fewer, but more experienced examiners and better technology designed to eliminate some of the administrative drudgery that is currently a part of the community bank supervision process.

We may find that the community bank exam team of the future will comprise an OC-16, with an assisting OC-10 or OC-12. I suspect our community bankers would welcome such an approach. They would benefit from the insight a more experienced examiner can provide, while at the same time gain a significant reduction in the burden associated with our exam activities. From our standpoint, such an approach is likely to result in better-quality supervision at a lower overall cost. To get a jump start on this critical initiative, we have already asked Barbara Healey, Jimmy Barton, and Dean Marriott to oversee a reassessment of our community bank supervision process. And work on this particular initiative has already begun.

We will be looking at ways to improve our ability to identify and respond to emerging risks. Scott Calhoun,

in his new role as the OCC's first risk czar, will be focused on developing better ways to detect emerging risks and devising timely regulatory responses to those risks.

Finally, we will also be thinking about, and developing, a strategy for supervising banks in the next economic downturn. I don't think any of us care to relive our days as the so-called "regulator from hell." But I think we have much to learn from that experience. Using that experience, we need to explore whether other, more effective, approaches exist for dealing with problem situations. Our supervision by risk philosophy, combined with a more experienced, skilled workforce should enable us to detect problems earlier. But now — while the industry is in good condition and before problems surface — is the time to think about, and study, whether there are better approaches for dealing with the problems when they do occur.

As I have said, we are confident that supervision by risk is the most efficient and effective way of supervising individual banks as well as the national banking system as a whole. But, it will not work in practice, unless we develop a work force that can do the job right. We need to develop and maintain a staff that has the skills, the experience, and the knowledge to make the difficult judgments that are at the very heart of supervision by risk. We need to create an organizational structure that puts those employees where they can do the most good. And we need to provide our employees with the technological tools they need to do their jobs well in an increasingly complex banking environment. These issues are also addressed in the 1997 objectives.

The Executive Committee and the DMG will be working together closely to determine the steps necessary to move toward a smaller, more experienced, and more skilled workforce. The first step in achieving this objective is the draft Report on the Staff of the Future that you received yesterday.

The report outlines a proposed strategy we can follow to develop a workforce with the technical, decision-making, and risk-taking skills to keep pace with the changes occurring in the industry. You will see in the report that based on our best estimates of the amount of consolidation that is likely to occur — we need to take action to reduce OCC FTEs by 500 by year-end 1998, of which 300 will be reduced by year-end 1997. We believe this reduction will enable us to get "ahead of the curve" and provide us with the flexibility to do targeted hiring of people with the specific expertise needed to stay abreast of the new activities banks are getting involved in. We anticipate that a buyout coupled with careful counseling of employees will enable the OCC to achieve the necessary reductions and still maintain a highly skilled workforce.

I know it is tempting to get caught up in the mechanics for correcting our staffing imbalances such as what the terms and timing of the buyout offer are likely to be, but it is important that we do not lose sight of the overriding goal of our revised staffing strategy — having the right people with the right skills.

The report also addresses the need to provide field managers with additional flexibility going forward in managing your staffing numbers. Many of you suggested, and we agree, that it makes sense to manage overstaffing on a broader geographic basis — at the field office, rather than at the duty station level. The proposed staffing strategy would provide district management with additional authority to do that on a cost-justified basis.

Other options to provide you with more staffing flexibility include banding of OC-levels, which would enable you to offset averages at one grade level with shortages at the next grade level either up or down. Another option would allow you to convert precommissioned positions in the staffing plan to OC-12 positions at a ratio of 1.5 to 1. This option recognizes that the experience level of our workforce is increasing daily. It would be a first step in changing the composition of our workforce to one that is more experienced, but smaller.

During the conference, members of the Staff of the Future Working Group — Fred Finke, Roy Madsen, Gary Norton, Matt Roberts, Karen Wilson, and Ralph Sharpe — will meet with you to discuss the report in more detail. The working group has made tremendous progress in rethinking our staffing strategy since the August 13 announcement that we would be reassessing our overall staffing approach. However, in reading the staffing report, and discussing it with the working group members, please keep in mind that it has not been finalized, it is very much a work in progress, and several details remain to be worked out.

It is important to keep in mind that buyouts are only one component of ensuring we have a workforce made up of the right people and the right skills to do the job.

You will see under the workforce objective that we will also be evaluating our performance management process during 1997. We want to make sure that we are measuring our employees against the right performance measures and that those performance measures are being consistently applied in determining performance ratings and career progression.

We also want to do a better job of identifying the specific knowledges and expertise our workforce will need in the future. In conjunction with Human Resour-

ces, the DMG commissioned a work group, headed by Delora Jee, to develop a process for doing that.

We will also be looking at improving the OCC's management development process, developing new or modified training programs, and providing each employee with the information, incentives, and support systems necessary to manage his/her career.

You play a very critical role in our efforts to reshape our workforce. You will be expected to counsel your employees as a part of this effort. And you will need to manage the diversity of your staff and recognize that the needs of each employee may be different. These are parts of a manager's job that can receive short shrift in the midst of dealing with almost daily crises. But they are parts of the job that will have the greatest impact on the success or failure of our workforce initiative.

It goes without saying that we need to identify the best organizational structure to support efficient operations and full integration of our supervision by risk philosophy. The Executive Committee has just this past week received the ORT Structure Team's final report. We are currently scheduled to receive a briefing and discuss the report with the team on September 24. I am sure that you have heard a lot of rumors about what the future structure of the OCC may be. In fact, you may have heard a recent rumor that we plan to make a "big" announcement regarding structure at this week's conference. I hate to disappoint you, but since we just received the ORT Structure Team's report and haven't even had the opportunity to discuss it yet, we are obviously not in the position to do that. As I said, we will be discussing and considering the structure team's findings in the very near future.

A more complex and consolidated banking industry means we must do our work better, smarter, and faster. In addition to having the right people and right organizational structure to do the job, we are committed to providing you with the technological tools necessary to do your jobs more efficiently. Steve Cross will demonstrate this week the significant progress that has been made on the Examiner View project — we plan to begin testing it in the field over the next few months. You can also expect expansion of the LAN and greater access to analytical systems such as IBIS, ISIS, and MARS during 1997.

Equally important as the objectives I have just mentioned are four other objectives that plan to focus on during 1997. These include:

(1) Developing better measures of the effectiveness of our various programs, processes and projects. This will build on the work of the ORT and the Quality Assurance Team.

(2) Developing a process to better incorporate the Access to Financial Services pillar into OCC operations, which will build on the work of the external relations staff and the outreach within districts.

(3) Continuing the work we initiated this year in electronic banking.

(4) And, probably most important, improving our internal communications.

In establishing our 1997 objectives, we have set an admittedly aggressive game plan. To assist us in ensuring we accomplish our gameplan, the Executive Committee has selected Kevin Bailey from the Chief's Office, Steve Cross from Examiner View, Kay Kowitt from the WED, Beth Pile from the NED, Lenny Reid from IRM, Rusty Thompson from the SWD, and Sue Thompson from the MWD to serve as coordinators/project leaders of the various objectives. They will spend the next year shepherding the objectives to completion. As a first step in their new assignments, they will be asking for your input on how to best achieve the 97 objectives during the breakout sessions later this morning.

Equally important to the objectives I have just described is how we communicate expectations and changes throughout the agency. It is up to each of you to communicate the message from this meeting to your employees. We have included an article in your conference material titled "Reaching and Changing Front-Line Employees. " This article indicates that front-line supervisors — not senior management — are the true opinion leaders in an organization. That is why it is critical that you talk to your employees about the issues being discussed at the conference.

One thing I think you — as opinion leaders — should emphasize to your staffs is the importance of teamwork. Much of the OCC's best work this past year was the result of coordinated efforts. Some of our best exams, for example, are those being done by examiners in concert with other professionals — such as economists, accountants, and capital markets experts.

And some of our best policy issuances are the direct result of bringing our field staff's expertise and experience to the policy making process.

Furthermore, our victories in the courts to expand bank powers and our efforts to shape favorable legislation for the industry could not have been achieved without the efforts of an array of lawyers, policy analysts and those who work with trade organizations, Congress, and the public on a daily basis.

One of the things I tried to do since taking on my new responsibilities is to remind the agency of the common ground that exists between Washington and the districts and urge both groups to come together to achieve our common objectives. Historically, the field and various Washington divisions have not had to focus a lot of attention on coordinating our activities and working together. However, we are becoming more and more dependent on each other to improve efficiency and effectiveness, and to respond to the ever-evolving industry we supervise. Going forward it will be critical to our success that we operate as a unified organization working toward common goals.

I have talked about some of the initiatives we must take to position the agency for the future. We plan to spend a considerable amount of time during this conference getting your ideas on the best way to implement these initiatives. Before I close, I must say that as we work toward accomplishing these initiatives over the next year, it is important that we not lose sight of our core business function — the first pillar — ensuring the safety and soundness of the national banking system.

As Comptroller Ludwig mentioned, the OCC — and each of you individually — must continue to do the fine job that you have been in identifying potential problems and taking the actions necessary to respond before they cause significant harm to individual institutions or to the industry as a whole. That is our primary job and it is critical that we continue to do it well.

This conference gives us the opportunity to think and talk about where this organization must go and what we — as its leaders — must do to move it in that direction. I am hopeful that the next two days we spend in Detroit will strengthen our resolve to work together in order to accomplish that.

# Remarks by Eugene A. Ludwig, Comptroller of the Currency, before the Department of the Treasury Conference on electronic money and banking, on emerging technology and the role of government, Washington, DC, September 20, 1996

As your luncheon speaker today, I'm the mop-up pitcher at this conference. I hope that you have found this meeting worthwhile — I know I have. I want to take this opportunity to thank our speakers and panelists for doing an outstanding job. i also want to thank my own staff at the OCC and staff from the other Treasury bureaus who have also done an outstanding job of taking care of all the logistics necessary to make a conference like this a success.

Now, of course, the problem with mopping up today is that earlier speakers have already hit the ball out of the park. Or put another way, I feel a bit like the balloon act at the circus after a bunch of tigers have already done a high wire act.

On the other hand, there is something to be said for having the last word. So let me take advantage of that opportunity by offering a few thoughts about what we have heard over the past day and a half.

First, the fundamental value of a conference like this is that it gives the private sector and the public a chance to pick up some of the drum beats — the preliminary thinking, if you will — of government policy makers. Of course it goes both ways — it also gives us a chance to listen in on what industry and consumers are thinking. This exchange of information allows us to work together to develop solutions to significant issues — solutions that do not involve heavy-handed regulation. Industry and consumers have the chance to devise solutions to concerns identified by government, and government gains a better understanding of the opportunities and constraints facing the private sector and the general public.

Conferences like this one, plus careful study of the issues, minimize the need for regulation. They ensure that, if regulation does become necessary, it addresses the issues involved without unduly burdening the market.

Second, a number of themes began to emerge in virtually all the presentations we have heard over the past two days. Perhaps the most significant is the importance of trust. The new marketplace offers businesses new opportunities for increased efficiencies, larger markets and greater profits, and offers consumers greater convenience and access to new products and services. At the same time, how useful this marketplace becomes depends on how much confidence participants — particularly consumers — have in its dependability and integrity. We heard different views on what is required to develop this trust — assurances of privacy, clear statements of liability if systems fail, elimination of fraud, the need for some form of disclosure. But everyone agreed trust is the key to developing a robust E-money system.

It was also interesting to me to see the wide range of opinions about how quickly electronic money will develop. I think the consensus at the conference is that the market is developing rapidly, although opinions differ — sometimes dramatically — on what may reasonably be expected in the near term. But while there is disagreement on the precise pace of change, there is clear agreement on the need to plan for and develop risk management systems for e-money systems. And there is also agreement that rapid and continuing changes in technology will make this planning all the more difficult.

Equally important, throughout the conference, it has become clear that there is an international dimension to virtually all the major issues discussed at this conference. For example, in one of the discussions, a panelist pointed out that one possible solution to the potential misuse of smart cards to facilitate financial crimes would be to establish limits on how much value could be stored on a card. But that would only work, the panelist said, if these load limits are the same in all countries.

Thinking about these themes, I am coming to the view that certain attributes are essential to an orderly market for electronic money and banking. Let me mention some of the most important.

*Transactions should be enforceable and reliable.* Many basic legal questions concerning electronic commerce remain to be resolved, and the resolution of these issues is essential to building confidence in electronic money transactions. These questions are compounded by the borderless nature of electronic commerce. It is unclear what laws apply in many transactions, or what courts have jurisdiction to resolve disputes. In individual cases, it may be possible to settle some differences through contractual arrangements. But the market may not develop as quickly if transactions continue to be governed solely by contractual agreements.

*The market should be largely free of fraud.* The market should facilitate efforts to enforce laws against financial crimes and unsafe and unsound practices. At the same time, the concerns of law enforcement must be balanced against consumer privacy concerns.

*Consumers must have reasonable protection from abuse of privacy.* New technology facilitates the accumulation and manipulation of vast quantities of personal information. This has already led to rising public concern about who has access to that information and how it is used. In addition, foreign governments already are imposing their own privacy standards. To accommodate a truly functional international market will require attention to the privacy concerns of our citizens.

*Consumers must have adequate information to make informed choices.* They need adequate information about the payment systems they are using, as well as the products they are buying.

*Consumers need to understand the risks involved with using electronic money and banking products and conducting commerce over the Internet.*

*Development of new electronic forms of payments must not get in the way of broad consumer access to financial services.* As the payments system evolves, we must make certain its evolution does not impede access to financial services for people who currently have such access. In addition, these new forms of payment services offer opportunities to serve those who are now unserved by the financial services system. It is in all our interests — public and private — to take full advantage of these opportunities.

Now, as to the role of government in facilitating a vigorous market that has these attributes, my own view is that we in government must be guided by three principles:

- First, we should work with the private sector and the public wherever possible. Electronic money and electronic payments are evolving so rapidly that government cannot possibly develop and retain all the expertise necessary to accomplish any of its objectives without the support and cooperation of industry.

- Second, we should avoid premature regulation. We recognize the dangers of involving government too early in such a rapidly evolving area and do not want to chill or unduly influence the market by encumbering it with regulation that may quickly become outmoded, inappropriate, or detrimental.

- Third, we should be prepared to take action when action is required. While we are mindful of the dangers of acting prematurely, waiting too long to address problems also will impede the full development of this promising market.

That brings me to the next steps Secretary Rubin mentioned in his speech yesterday morning. The study sponsored by the G-7 will, for the first time, bring together central bankers, bank regulators, finance ministries, and law enforcement authorities from each of the G-10 countries to address electronic money and banking issues from an international perspective. They will build on the work of other international groups that have already begun to study these important issues. And they will identify gaps — areas where international cooperation is needed but where no action or study has yet begun. This is important because electronic money is truly an international phenomenon. The simple fact is that we cannot afford to have these new beneficial technologies disrupted by international pirates. And, as I said a moment ago, countries must find ways to cooperate to provide greater security and certainty to participants in electronic money and electronic commerce systems.

The Consumer Electronic Money Task Force is also a critical next step. This Task Force will bring together relevant federal governmental policy makers — the Treasury Department, the Federal Reserve, the FDIC, and the Federal Trade Commission — to address in detail many of the consumer issues raised at this conference. Issues such as how to ensure appropriate disclosure of the characteristics and risks of E-money products, and how to avoid its evil twin, consumer confusion . . . how to protect consumers against fraud . . . how to promote broad access to new products and technologies . . . and who should bear the liability when transactions go wrong. We will meet within the next several weeks to begin a full examination of these and other questions. And let me assure you we have no intention of working in a vacuum — we must and will depend heavily on input from industry and consumers as we tackle these issues.

Let me conclude by saying this has been an exciting conference for me, not just because we have had first-class speakers but because this is an exciting subject. Electronic money and banking are more than important changes in the way financial services are delivered. They are nothing less than a revolution in financial services that holds great promise for Americans and for people around the world. It holds the promise of new products and new markets for providers, and greater convenience and access to financial services for all consumers. It is the possibility of making this promise a reality — while at the same

time avoiding the pitfalls — that makes the issues surrounding electronic money not only timely but exciting.

As we move into the information age of the 21st century, our nation can and should be a leader in the development of electronic money and banking products. Our private sector and our markets have the capability of this leadership. It is therefore incumbent upon those of us in government to work with the private sector to achieve this promise. That is what we intend to do.

# Remarks by Eugene A. Ludwig, Comptroller of the Currency, before the Consumer Bankers Association, on access to financial services, Chicago, Illinois, September 30, 1996

This afternoon, I would like to frame my remarks around some intriguing possibilities — possibilities that should challenge the banking industry to explore what it can bring to the task of providing financial services to more American families . . . possibilities that force us to think about what banking, the country, and the economy have to gain if we can find solutions to the challenge of serving a virtually unexplored and untapped financial frontier.

But before I speak to you as bankers, I want to speak to you as Americans.

Henry David Thoreau once wrote that frontiers are not east or west, north or south, but wherever a person fronts a fact. Here are some of the facts we all front.

Today, 12 million American households do not have deposit accounts with a financial institution. That is fully 12.5 percent of our citizens who are not fully integrated into the financial services marketplace — more than the combined populations of Chicago, New York, San Diego, and Dallas.

We do not know nearly as much as we should about these people. We do not fully understand their financial needs. We do not fully understand how they meet those needs, although we know they do not participate in the financial system as fully as the mainstream population. And although lots of people from a lot of different perspectives are quick to speculate, we do not really know much about why they choose not to participate in the banking system.

But we do know that full participation in the financial system brings very real benefits to households in the economic mainstream. Walking around with a wallet full of cash is more dangerous, physically and financially, than walking around with a checkbook or a credit card. Cashing a check with a check cashing service characteristically costs a lot more than cashing one with a bank. Your chances of accumulating wealth and building a bridge to an economically secure future seem pretty clearly better if the place you keep your surplus resources is a savings account or a mutual fund, rather than a cookie jar or the underside of a mattress.

These things seem clear to me — I suspect they seem clear to most of us. But, at least to judge from the choices they make in the marketplace, 12.5 million American households do not find them so clear.

Why they do not is an important question that demands a thoughtful hearing. It is also a question whose answer may open the doors to greater opportunities for financial services providers both smart enough to find ways to gain new competitive advantages and determined enough to forge relationships with different types of customers.

Stereotypes cannot help us understand who comprises these 12 million households. They encompass many faces and many facets of today's America. They are minority families, one-third of whom do not use checking accounts. They are young Americans. One out of every six Generation Xers doesn't use checking or savings accounts and didn't grow up with the same affinity toward the institution of banking as the Baby Boomers. They include new and small entrepreneurs. Eleven percent of businesses with assets under $25,000 do not pay their suppliers or employees with bank checks. They include the working poor. Sixteen percent of American families earning between $10,000 and $25,000 turn to sources other than banks to cash their paychecks — and rarely get the type of financial advice that could enable them to manage their money better.

These are dramatic numbers, but they get even more dramatic in the context of some additional projections. By the year 2010, one-third of the U.S. population will be minority. In 15 years, minorities will represent half of the population of our nation's largest state. Many of the fastest growing metropolitan areas are in California, Texas, and Florida — states with high percentages of Hispanic households and other minorities. Also, consider that the average size of firms is getting smaller, with companies between 20 and 500 employees the fastest growing segment of American business. These — along with the growing legion of consultants and temporary employees — are exactly the kinds of firms and individuals that one might think would value relationship banking and could benefit from bank assistance to establish credibility in other financial markets.

And here is another fact to bear in mind. By the year 2010, the segment of the population that has lived in the wake of the heralded Baby Boom generation will

finally find that their influence on markets equals that of their aging counterparts. How those newly powerful consumers vote with their feet will determine the fate of many American businesses. But listen to what many of them are saying already. They are saying they do not fit our standard stereotype of America's young. In contrast to their image, young age groups are seriously thinking about their retirement years, and — according to a recent survey — 69 percent of those in their 20s "wanted help choosing investments to fund their retirement."

What kind of country and economy could we have — today and in the future — if these 12 million American households were better served by the country's financial services industry?

We could have an economy in which 12 million more households had better opportunities and did a better job of accumulating wealth through more disciplined savings and more strategic investing — wealth that could mean the difference between renting or owning a home . . . wealth that could mean the difference between sending a teenage son or daughter out into the workforce or off to college . . . wealth that could mean the difference between retirement years spent blissfully or tragically.

We could have an economy in which those who now spend more than they should have to just to cash a paycheck could stretch their hard-earned dollars just a little farther. In our toughest urban neighborhoods, the streets could be just a little safer if residents carried fewer of their assets on their persons and kept more of them in depositories. And our small business sector could be a bit more vital if the smallest businesspersons could tap better capital and counsel to help realize their dreams of expansion and growth.

These are not pipe dreams. They are very real possibilities — but possibilities that can only be realized by making the pursuit of solutions a priority. Secretary Rubin has long advocated the importance of equipping today's financially underserved and unserved for the economic mainstream. As the Secretary said in Los Angeles earlier this year, ". . . unless we succeed in that endeavor, all of us — no matter where we live or what our incomes — will be powerfully affected, in lost potential for our economy and in a worsening of the conditions in which we live."

Deputy Secretary Summers and Under Secretary Hawke have also been strong leaders on these issues. Under Secretary Hawke currently heads the Treasury's Electronic Funds Transfer working group, which is responsible for implementing new legislation requiring that all federal payments — everything from federal wages and retirement payments to social security and veterans benefits — be made by electronic transfer after January 1, 1999. Clearly, how this law is implemented could significantly change the way in which many of the 12 million households I have described interact with the existing financial system.
Let me now speak to you as bankers.

The increasing importance and success of the Consumers Bankers Association reflects the fact that the business of banking is increasingly consumer focused and increasingly successful in serving the needs of middle-class American consumers. In response to the realities of an evolving financial services marketplace, America's commercial banks are becoming increasingly central to the financial needs of American families. To an unprecedented and still growing extent, our commercial banks are playing enhanced roles as providers of home mortgages, mutual funds, credit cards and insurance products. As a result, today — for the first time in American history — consumer loans outpace commercial loans as a source of business for commercial banks, with consumer loans accounting for 27 percent of bank assets compared to 25 percent for commercial loans.

The largest and fastest growing area of consumer lending is in loans secured by residential real estate, a segment of bank business that has more than doubled since 1986. Mutual fund sales have also grown rapidly, with the volume of mutual funds sold through banks more than quadrupling from 1990 through the end of last year, up from $86 billion to nearly $400 billion. As you are well aware, the OCC has worked closely with the industry and consumer leaders in a way that has both facilitated that growth and protected consumers.

Banks are also beginning to serve middle-class consumers in new ways. Although credit card loans account for less than 5 percent of total commercial bank assets, the growth has been dramatic over the last three years. And again, the OCC is working with industry and consumer group leaders to ensure that this market develops responsibly and functions with the consumer's interest in mind. Last week, we issued an advisory letter on preapproved credit card solicitations, reminding national banks of the risks of some of these programs and identifying specific steps to address possible weaknesses in credit card portfolios. And banks are beginning to provide their customers with more insurance products. Today, one out of five Americans has purchased life insurance from a bank, and that number will only grow in the years to come. The OCC has been working closely with the CBA and other bank trade groups to ensure that the expansion of the banking business into these areas goes smoothly for banks and consumers alike.

Home mortgages, mutual funds, credit cards, life insurance — bank entry into these markets has given middle-class consumers the benefits of a more competitive financial services marketplace and has challenged the banking industry to be more customer-focused and consumer-sensitive.

Competition and industry focus have given thousands of mainstream consumers greater options, lower prices, and better services — and, not coincidentally, helped fuel record profits for the nation's banks. In all of these areas — mortgage lending, credit card lending, insurance sales, mutual fund sales — the banking industry has in recent years made a convincing show of its ability to develop and apply new competitive skills to new market areas.

But what about those 12 million households? Is it possible today that some of the new competitive skills the industry has gained in these product markets could be applied to accomplish greater, profitable involvement in a new demographic market? Is it possible that new innovations in product design or delivery, or new technologies, could enable the banking industry today to extend the reach of its service profitably beyond the middle class of consumers and into the unserved portion of the consumer marketplace?

Is it possible? I don't know. It's an important question — a question worthy of serious discussion, both as a policy matter and as a business proposition. But I don't have all the answers.

Clearly, there are a number of reasons why banking has not fully addressed the needs of this market segment before. First, we regulators and other government policymakers have too often been part of the problem, discouraging — not encouraging — innovation. For example, at the end of the last century we essentially prohibited commercial banks from making home mortgage loans. In the 1920s our examiners viewed auto loans as a basically unsound business. Moreover, banks have been so restricted by laws and regulations in the products and services they could offer for so long that I believe the innovative spirit of banking had been stifled.

Second, the underserved and unserved market itself is different today than it was even 25 years ago and it continues to evolve so that new understanding and new approaches are continually needed

And third, the cost structure of retail banking is such that it often stands as a barrier to investments in traditional brick and mortar delivery channels.

As I said a minute ago, I don't come here today with all the answers. But even without the answers, I can bring more than questions to the table.

So let me close with two concrete actions we are taking at the OCC to explore the possibilities, seek market-based solutions, and provide incentives for banks to forge relationships with those who are outside the financial service industry's current reach.

First, we will convene an educational forum to seek ways of using new technologies and other new approaches to serve those without banking relationships. We will seek input from a variety of sources, including financial services industry management; developers, manufacturers, and vendors of new technologies; social scientists; and consumer representatives — all focusing on the question of what seems to work and what seems not to work in efforts to extend the mainstream market for financial services to those currently outside that market. This one-day forum, which will be held this coming winter, will highlight a number of key topics that require greater attention. I am pleased to say that the Consumer Bankers Association has agreed to co-sponsor this event.

My hope is that in the course of that discussion, we can get a better understanding of some of the aspects of this challenge that seem to get less attention than they probably deserve, such as the effects of culture and language differences. A member of my staff recently pointed out to me that in many immigrant communities, one of the key virtues of a financial institution may be its ability to reliably transfer funds to family members in an immigrant's native country. Simple facts like that may provide insights into appropriate product and service design: perhaps the provision of fund transfer services to immigrant populations could prove an effective point of entry into a more robust relationship with a financial institution.

We may also find that some of the conventional notions about why certain populations do not use banking services may be no more than notions. For example, I have often heard it said that those who do not now use banks have a cultural aversion toward the institution of banking, or are uncomfortable with technology, or are unable to manage bank services without extensive training. In fact, it is not at all clear how many of these notions are true. When asked, many of those without checking accounts say the real reasons are just simple economics — initial or minimum balance requirements they just cannot afford. By deepening our understanding of this population, we can refine our judgments about whether and how it is possible to bring it into the mainstream of financial consumers.

I also hope and expect we will discuss the role technology might play in reaching out to these 12 million households. As technology lowers unit costs, it may become feasible to provide certain services at significantly lower cost than ever before. Perhaps in conjunction with product design innovations, price reductions flowing from technological innovations may enable the extension of the financial service marketplace to many low-income households.

These are just a few of the topics we need to explore. My hope is that the OCC might assist that exploration by stimulating discussion, collecting information, sharing it with the industry and enabling banks to conduct their own — more targeted — research to design products and delivery methods most appropriate to the emerging markets and niches they wish to reach.

In addition to providing a forum for extensive dialogue on the challenges of the underserved and unserved, the second concrete action we are taking is to make it easier and less costly for banks to do business in these communities. Because while research and analysis is important, there's no substitute for relationships and understanding built on face-to-face, direct contact with existing and potential customers.

So today I am announcing a policy change that will encourage national banks to locate in underserved communities. The OCC is waiving fees for applications for new charters and branches in low- and moderate-income census tracts not currently served by a depository institution. This is a small step, not a big one. Of course we hope it will have positive effects, but I do not delude myself with the thought that the elimination of some fairly minor fees will eliminate access to financial services problems in the inner city. But what I want you and everybody else to see is this: I believe there is an important chunk of our society that could benefit from greater interaction with your industry, and I am committed to the notion that the OCC should not put barriers in the way of that interaction.

For banks today, success is not simply a question of gaining new powers — it is a matter of gaining new insights, new products, and new capabilities to take advantage of both emerging market opportunities and previously untapped markets. And for banking today, success in the retail area is not simply a question of serving part of its potential market but reaching out for underserved or unserved customers and turning them into profitable or more profitable relationships.

The country's banking industry must develop relationships now with the fastest growing segments of our population if it is to occupy the same place and fulfill the same role in the 21st century as it has for much of this century — center stage in financial services and the driving force for economic advancement. Yes, there are other providers of financial services today — there long have been and there always will be. But I still believe that banks offer the best opportunities for the greatest number of this nation's individuals and enterprises.

Banks have helped generations of American families and communities achieve their dreams, providing them the means to get a start in life or to reach the next rung on the ladder of economic progress. It is time now to focus on serving America's next generations and tomorrow's consumers. I am confident that, working with those of you who feel the same way, the banking industry can explore the many possibilities, and make the possible achievable.

# Interpretations — July 1 to September 30, 1996

## 709 (revised) — July 1996

Dear Sir/Madam:

This letter replaces our letter dated February 21, 1996, which responded to your request for clarification about the extent to which an institution that invests in a Community Development Bank (CDB) may obtain positive consideration under the lending test portion of the Community Reinvestment Act (CRA) regulations published May 4, 1995. *See* 60 Fed. Reg. 22,156 (May 4, 1995). Staff from all four of the financial institution regulatory agencies have reconsidered the issues you raised, and they concur in the opinions expressed in this letter.[1] As discussed below, an institution that invests in a CDB may obtain favorable consideration under the regulation's investment test, or it may choose to have a portion of its investment evaluated under the lending test and the remainder evaluated under the investment test.[2]

The CRA was designed to encourage institutions to help meet the credit needs of their entire communities, including low- and moderate-income areas, consistent with safe and sound lending practices. The new regulations set out a number of different tests for examiners to use in evaluating CRA performance, depending on the type of activity and the size and type of institution. Your letter focuses on whether institutions' investments in the CDB will receive positive consideration under the lending and investment tests. Our response, therefore, addresses consideration under the lending and investment tests, which are applicable primarily to large institutions.

The lending test evaluates an institution's lending activities by considering the institution's purchase or origination of home mortgage, small business, small farm, community development, and, in some instances, consumer loans. Among the performance criteria considered in the lending test is an institution's community development lending, including the number and amount of community development loans and their complexity and innovativeness. *See* 12 CFR 25.22(b)(4), 228.22(b)(4), 345.22(b)(4), and 563e.22(b)(4). A "community development loan" must have community development as its primary purpose and, except in the case of wholesale or limited purpose banks, must benefit the institution's assessment area(s) or a broader statewide or regional area that includes the institution's assessment area(s). *See* 12 CFR 25.12(i)(1) & (2)(ii), 228.12(i)(1) & (2)(ii), 345.12(i)(1) & (2)(ii), and 563e.12(h)(1) & (2)(ii). The regulation allows an institution that invests in a community development financial institution, such as a CDB, or other entity that uses the institution's investment to make loans to receive consideration under the lending test for its pro rata share of community development loans made by the entity. *See* 12 CFR 25.22(d), 228.22(d), 345.22(d), and 563e.22(d).

The investment test evaluates an institution's number and amount of qualified investments, the innovativeness or complexity of its qualified investments, the responsiveness of the qualified investments to credit and community development needs, and the degree to which the qualified investments are not routinely provided by private investors. *See* 12 CFR 25.23(e), 228.23(e), 345.23(e), and 563e.23(e). Qualified investments include lawful investments, deposits, membership shares or grants that have as their primary purpose community development. *See* 12 CFR 25.12(s), 228.12(s), 345.12(s), and 563e.12(r). To be considered under the investment test, qualified investments must benefit the institution's assessment area(s) or a broader statewide or regional area that includes the institution's assessment area(s). *See* 12 CFR 25.23(a), 228.23(a), 345.23(a), and 563e.23(a). Qualified investments include, but are not limited to, investments in CDBs that primarily lend in low- and moderate-income areas or to low- and moderate-income individuals to promote community development and investments in state and municipal obligations that specifically support community development. *See* 60 Fed. Reg. at 22,162 n.3.

As noted above, an institution may choose to have its investment evaluated entirely under the investment test, or it may choose to have a portion of its investment evaluated under the lending test and a portion evaluated under the investment test. However, in doing so, the institution must provide the appropriate supervisory agency with the necessary information to calculate the breakdown between the two components.

An example may help to illustrate how an institution's investment in a CDB may be considered under the CRA regulations. Assume an institution invests $1 million in a CDB that has a total capitalization of $10 million. The CDB, in turn, holds total assets of $30 million, with $12 million in qualified investments and $18 million in com-

[1] This letter supersedes the February 21, 1996, letter in its entirety. Because this letter replaces the previous letter, we have substantially reiterated herein the portions of the previous letter that remain valid (with some minor edits for clarity). This letter contains a revised formula for determining the amount of community development loans made by a CDB in which a financial institution has invested for which the institution may receive consideration under the lending test.

[2] This letter addresses only CRA consideration for an investment in a CDB. It assumes that such an investment is legally authorized; however, it does not authorize such an investment. In a separate letter dated February 1, 1996, the OCC approved a national bank's investment in the CDB as a community development investment under 12 USC 24 (eleventh) and 12 CFR 24.

munity development loans. The investing institution could choose to have its investment considered only under the investment test. If the institution chooses this option, the amount of the qualified investment would be $1 million, the total amount of the institution's investment.

Alternatively, the investing institution could request consideration under both the investment and lending tests. The amount attributed to the investment test would equal the product of the institution's investment in the CDB and the percentage of the CDB's asset portfolio that is comprised of qualified investments. The amount attributed to the lending test would equal the investing institution's pro rata share of community development loans originated by the CDB during the period under review.

Applying these principles to the example above may help to clarify how an institution's investment in a CDB may be attributed between the investment and lending tests. In the example, qualified investments comprise 40 percent of the CDB's total assets ($12 million of total assets of $30 million). Thus, under the investment test, the investing institution would receive consideration of 40 percent of its total investment in the CDB, or $400,000. It is assumed that the remainder of the institution's investment has been used to fund community development loans in an amount equal to the institution's pro rata share of loans originated by the CDB. The institution has supplied 10 percent of the capital of the CDB, which provides the basis for determining, under the lending test, the institution's pro rata share of community development loans made by the CDB. Assuming the CDB's $18 million in loans were originated during the period under review and benefit the institution's assessment area(s) or a broader statewide or regional area that includes the institution's assessment area(s), the institution's pro rata share of these loans would be $1.8 million. Therefore, the institution may receive consideration for $1.8 million in community development loans under the lending test.

I trust this letter is responsive to your inquiry. You may also be interested to know that the staffs of the four financial supervisory agencies are presently developing official guidance for the public to aid in resolving interpretive questions arising under the new CRA regulations.

Matthew Roberts
Director
Community and Consumer Law Division
Office of the Comptroller of the Currency

* * *

# 726 — July 1996

Dear Sir/Madam:

This responds to your inquiry regarding the application of the Community Reinvestment Act (CRA) regulations to a financial institution's support of [*Company*]'s small business lending programs. As you probably know, the four federal financial supervisory agencies finalized new CRA regulations on May 4, 1995. *See* 60 Fed. Reg. 22,156 (May 4, 1995) (to be codified at 12 CFR 25, 228, 345 and 563e). The agencies' regulations are substantively identical. Therefore, staff from all of the agencies have considered the issues you raised, and they concur in the opinions expressed in this letter.

## Background

As your letter explains, [*Company*] provides access to credit and technical assistance for very small businesses (microenterprises)[1] in Latin America and the United States. Typically, microenterprises have difficulty obtaining credit because they lack collateral and the loans they require are often too small to be cost effective for most financial institutions. In the United States, the [*Affiliate*] acts as an intermediary between microenterprises and financial institutions to address these problems.

The [*Affiliate*] issues private placements of promissory notes with various investors. With the money it receives from these investors, the [*Affiliate*] issues letters of credit to financial institutions. The letters of credit guarantee a portion of each loan made by the financial institutions to [*Affiliate 2*]. The [*Affiliate 2*] use the loans from the financial institutions to fund their microenterprise lending (microlending) programs in New York, New Mexico, Illinois, Texas, and California. This system allows financial institutions to participate in microlending without bearing the risk of undersecured loans or incurring the costs of making those loans directly.

## Discussion

Based on the microlending program described above, you have asked whether: 1) a financial institution's purchase of a promissory note that funds guarantees

[1][*Company*] defines "microenterprise" as an informal business with ten or fewer employees and in which the owner actively participates. Financing microenterprises generally promotes economic development because microenterprises are typically located in low- or moderate-income areas and include street vendors, seamstresses, artisans, small shops and restaurants, shoemakers and carpenters. Microentrepreneurs and their employees are also frequently low- or moderate-income earners.

of loans to microenterprise lenders would be a qualified investment under CRA; 2) a financial institution would receive favorable CRA consideration for a loan to a microenterprise lender; and 3) a financial institution's loan to a guarantor, such as the [*Affiliate*], or microenterprise lender would qualify under the CRA investment test if the loan had a 10-to-20 year term, low interest rate, and deep subordination.

In addition, you have asked whether a financial institution would receive positive CRA consideration for the following proposed activities: 1) investing funds in a pool that would be managed by a microenterprise lender and used for microlending; or 2) purchasing a microloan portfolio from a guarantor or purchasing a security backed by such a portfolio.

Finally, you have asked whether the CRA regulations would place geographic restrictions on a financial institution's support of either the existing program or the proposed activities.

A. Questions based on [*Company*]'s existing microlending program.

1. Purchases of promissory notes.

A financial institution's purchase of a promissory note that funds guarantees of loans to local intermediaries that lend to microenterprises to promote economic development would be considered a qualified investment under the CRA regulations unless the purchase is carried on the institution's books as a loan.[2] The new CRA regulations provide a detailed framework for evaluating an institution's CRA performance. The new rules set out a number of different evaluation methods for examiners to use, depending on the business strategy and size of the institution under examination.

Regardless of the evaluation methods used by examiners, however, any financial institution can receive positive consideration for making a "qualified investment" that benefits its assessment area or a broader statewide or regional area that includes the assessment area.[3] The new CRA regulations define "qualified investment" as "a lawful investment, deposit, membership share or grant that has as its primary purpose community development." *See* 12 CFR 25.12(s), 228.12(s), 345.12(s), and 563e.12(r). "Community development" is defined to include, among other things, "activities that promote economic development by financing [small] businesses. . . ." *See* 12 CFR 25.12(h)(3), 228.12(h)(3), 345.12(h)(3), and 563e.12(g)(3).

A purchase of a promissory note that provides credit enhancement on loans to microenterprise lenders to promote economic development has as its primary purpose community development because the note enables microenterprise lenders to provide loans to small businesses that are located in low- or moderate-income areas or that provide jobs for low- or moderate-income persons. Assuming that the microenterprise lenders serve a regional area that includes a financial institution's assessment area, examiners would give positive consideration to a financial institution's purchase of promissory notes as a qualified investment under any of the new performance tests and standards in the new CRA regulations.

2. Loans to Microenterprise Lenders

If a financial institution makes a loan directly to a microenterprise lender to support the lender's financing of small businesses to promote economic development, its loan would be a community development loan under the CRA regulations. *See* 12 CFR 25.12(i), 228.12(i), 345.12(i), and 563.12(h). A "community development loan" is a loan that has community development as its primary purpose and, except in the case of a wholesale or limited purpose bank, benefits the institution's assessment area(s) and has not been considered as part of the institution's assessment as a home mortgage, small business, small farm, or consumer loan. 12 CFR 25.12(i), 228.12(i), 345.12(i), and 563e.12(h).

A large retail institution's record of helping to meet community credit needs through its lending activities is evaluated under the lending test. *See* 12 CFR 25.22, 248.22, 345.22, and 563e.22. Under the lending test, examiners consider an institution's originations and purchases of loans, including community development

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[2]If the purchase is carried on the institution's books as a loan, it would qualify as a community development loan for the reasons discussed below in the section concerning loans to microenterprise lenders.

[3]Examiners of large institutions, which are evaluated under the lending, investment and service tests, consider qualified investments under the investment test. *See* 12 CFR 25.23(a), 228.23(a), 345.23(a), and 563e.23(a). In a small institution examination, examiners may adjust an institution's loan-to-deposit ratio, if appropriate, based on lending-related qualified investments. *See* 12 CFR 25.26(a)(1), 228.26(a)(1), 345,26(a)(1), and 563e.26(a)(1). Qualified investments may also be considered to determine if a small institution merits an outstanding CRA rating. *See* 12 CFR pt. 25 app. A(d)(2), pt. 228 app. A(d)(2), pt. 345 app. A(d)(2), and pt. 563e app. A(d)(2). The community development test, which is appropriate for wholesale and limited purpose institutions, evaluates, inter alia, the number and amount of qualified investments. *See* 12 CFR 25.25(c)(1), 228.25(c)(1), 345.25(c)(1), and 563e.25(c)(1). And, finally, institutions evaluated on the basis of a strategic plan must include in their plan how they intend to meet the credit needs of their assessment area(s). They may meet credit needs through lending, *investment*, and/or services, as appropriate. *See* 12 CFR 25.27(f)(1), 228.27(f)(1), and 563e.27(f)(1) (emphasis added).

loans. *See* 12 CFR 25.22(a)-(c), 228.22(a)-(c), 345.22(a)-(c), and 563e.22(a)-(c). Community development loans may also be considered favorably in the evaluations of small institutions, wholesale and limited purpose institutions, and institutions evaluated based on a strategic plan. *See* 12 CFR 25.25(c), 25.26(a)(1), 25.27(f)(1), g(3)(i), and pt. 25 app. A(d)(2); §§ 228.25(c), 228.26(a)(1), 228.27(f)(1), g(3)(i), and pt. 228 app. A(d)(2); §§ 345.25(c), 345.26(a)(1), 345.27(f)(1), g(3)(i), and pt. 345 app. A(d)(2); and §§ 563e.25(c), 563e.26(a)(1), 563e.27(f)(1), g(3)(i), and pt. 563e app. A(d)(2). Thus, examiners would favorably consider as a community development loan a financial institution's loan to a microenterprise lender.[4]

### 3. Loans to a microenterprise lender or guarantor on favorable terms.

You have also asked whether a financial institution could receive consideration under the investment test for a loan to a microenterprise lender or guarantor that had a 10-to-20-year term, low interest rate, and deep subordination to other lenders. As discussed above, the investment test considers qualified investments, which are defined as lawful investments, deposits, membership shares, or grants that have as their primary purpose community development. As a general rule, the agencies would not view as a qualified investment a transaction that is carried on a financial institution's books as a loan.

## B. Questions related to [*Company*]'s proposed activities.

### 1. Investments in a microloan pool managed by a microenterprise lender.

A financial institution would also receive favorable CRA consideration for its investments in a pool that would be used to make microloans to promote economic development in a regional area that includes the institution's assessment area. Examiners would consider such an investment to be a qualified investment for the same reasons discussed above regarding purchases of promissory notes. Thus, for example, a large retail institution would receive favorable consideration under the investment test for investing in a microloan pool. *See* 12 CFR 25.23(a), 228.23(a), 345.23(a), and 563e.23(a).

In lieu of consideration for the investment under the investment test, a large retail institution may elect to have its examiner consider, under the lending test, originations and purchases of community development loans by a consortium in which the institution participates or by a third party in which the bank has invested. *See* 12 CFR 25.22(d), 228.22(d), 345.22(d), and 563e.22(d). Thus, a financial institution would be able to claim for CRA purposes its pro-rata share of the total loans originated from the pool. *Id.*[5]

### 2. Purchases of a microloan portfolio or portfolio-backed security.

A financial institution's purchase of a microloan portfolio would be considered a purchase of the individual loans that comprise the portfolio. If a loan met the definition of loans to small businesses contained in the Instructions to the Consolidated Reports of Condition and Income or Thrift Financial Reports, an institution's purchase of the loan would be considered a purchase of a small business loan under the CRA regulations. If a loan did not meet the definition of small business loans but met the definition of community development loans under the CRA regulations, an institution's purchase of the loan would be considered a purchase of a community development loan. A large retail institution's record of helping to meet community credit needs through its purchases of small business loans or community development loans is evaluated under the lending test. *See* 12 CFR 25.22(a)(1), 228.22(a)(1), 345.22(a)(1), and 563e.22(a)(1). Small business and community development loans may also be considered in the evaluations of small institutions and institutions evaluated based on a strategic plan.[6] *See* 12 CFR 25.26(a)(1), 25.27(f)(1), g(3)(i), and pt. 25 app. A(d)(2); 228.26(a)(1), 228.27(f)(1), g(3)(i), and pt. 228 app. A(d)(2); 345.26(a)(1), 345.27(f)(1), g(3)(i), and pt. 345 app. A(d)(2); and 563e.26(a)(1), 563e.27(f)(1), g(3)(i), and pt. 563e app. A(d)(2).[7]

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[4] In your letter, you also ask whether a financial institution's investment in the [*Affiliate*]'s loan loss reserve would receive favorable CRA consideration The staff of the federal financial supervisory agencies concluded recently that a financial institution would receive positive CRA consideration for its investments in, or loans to, a reserve fund for affordable housing loans *See* interagency letter published as OCC Interpretive Letter No 708 (February 16, 1996) (attached) Investments in a reserve fund for small business loans would receive comparable consideration

[5] For further discussion of the CRA treatment of loans by consortia or third parties, see OCC Interpretive Letter No. 673 (June 26, 1995) (investment in a community development bank) and interagency letter published as OCC Interpretive Letter No. 710 (February 21, 1996) (treatment of loans made by an affiliate)

[6] Wholesale and limited purpose institutions' small business lending activities would be considered under the community development test if the small business loans qualified as community development loans. *See* 12 CFR 25.25, 228 25, 345.25, and 563e 25

[7] In addition, a large institution would have to provide the loan documentation described in the CRA regulations' data collection, reporting, and disclosure sections *See* 12 CFR 25 42, 228 42, 345 42, and 563e 42

A financial institution's purchase of a microloan portfolio-backed security that financed microenterprises to promote economic development would be a qualified investment for the reasons set forth above in the discussion of purchases of promissory notes.

### C. Geographic restrictions on a financial institution's support for [*Company*]'s existing or proposed programs.

Under the CRA regulations, a retail financial institution's community development loans, investments, or services must primarily benefit its CRA assessment area but may also benefit a broader regional area (including a multiple-state area). Thus, a financial institution may receive favorable consideration for its support of a community development organization that operates on a statewide or regional basis that extends beyond the institution's assessment area(s). The community development organization's scope must include the financial institution's assessment area(s) so that the institution's investment potentially benefits its assessment area(s). The more direct or certain the benefit, the more likely it will be viewed as particularly responsive to community credit needs. Thus, examiners will give greater consideration for investments, loans or services that more directly benefit the institution's assessment area(s).

In order to receive consideration for its participation in such a community development organization, an institution must provide its examiner sufficient documentation to demonstrate that its investment benefits a regional area that includes the institution's assessment area. An institution need not document the location of each community development loan that results from its investment. *See* 60 Fed. Reg. at 22,172.

### Conclusion

I trust this has been responsive to your inquiry. You may also be interested to know that the staffs of the four financial supervisory agencies are presently developing official guidance for the public for resolving interpretive questions arising under the new CRA regulations.

Matthew Roberts
Director
Community and Consumer Law
Office of the Comptroller of the Currency

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## 727— July 1996

Dear Sir/Madam:

This letter responds to your correspondence dated May 1, 1996, and May 10, 1996, concerning the treatment under the revised Community Reinvestment Act (CRA) regulations of the proposed purchase by the bank of certain "equity equivalent" instruments to be offered by a nonprofit community development lender ("the lender").* As you know, the four bank and thrift regulatory agencies have promulgated substantively identical CRA regulations. 12 CFR 25, 228, 345, and 563e. Therefore, staff from all of the agencies have considered the issues you raised, and they concur in the opinions expressed in this letter.

You have asked whether the bank would receive favorable consideration under the CRA regulations for its purchase of the equity equivalents. As explained more fully below, the purchase of the equity equivalents would be a qualified investment that examiners would consider under the investment test provided that the investment benefits the bank's assessment area(s) or a broader statewide or regional area that includes the assessment area(s). Alternatively, the bank could ask examiners to consider in its lending test evaluation its pro rata share of the community development loans made by the community development lender, again provided the loans benefit the bank's assessment area(s) or a broader statewide or regional area that includes the assessment area(s). Finally, in some circumstances, the bank could receive consideration for part of the investment under the lending test and part under the investment test.

### Background

The lender is a nonprofit organization and therefore cannot issue equity stock. However, you state that the lender intends to issue equity equivalents that will be identical to stock in key respects. As explained in your letter, the equity equivalents will be booked by the bank as investments following generally accepted accounting principles; will constitute general obligations of the lender that will not be secured by any its assets; will be fully subordinated to the right of repayment of all other creditors of the lender; generally will not permit the

*The scope of this letter is limited to whether investments by the bank in the equity equivalents would receive favorable consideration under the CRA regulations. This letter does not address whether the bank may lawfully make this investment. Furthermore, the agencies do not endorse particular investment opportunities offered to banks and thrifts.

bank to accelerate payment of the instrument; will carry an interest rate that is not tied to any income received by the lender; and will have an initial 10-year "tenor" that annually will be rolled back to a new 10-year tenor.

You state that the lender will use the funds provided by the equity equivalents to garner other investments and grants and to make loans to its community development financial institution (CDFI) members. The CDFIs, in turn, will use the funds to support their community development programs, which involve providing credit for affordable housing and small businesses to revitalize low-income areas throughout the United States.

## Discussion

The new CRA regulations set out a number of different tests for examiners to use in evaluating CRA performance, depending on the size and business strategy of the institution. The CRA performance of a large institution, such as the bank, is typically evaluated under the lending, investment, and service tests.

The investment test evaluates an institution's number and amount of qualified investments, the innovativeness or complexity of its qualified investments, the responsiveness of the qualified investments to credit and community development needs, and the degree to which the qualified investments are not routinely provided by private investors. *See* 12 CFR 25.23(e), 228.23(e), 345.23(e), and 563e.23(e). Qualified investments include lawful investments, deposits, membership shares or grants that have as their primary purpose community development. 12 CFR 25.12(s), 228.12(s), 345.12(s), and 563e.12(r). Community development means: affordable housing for low- or moderate-income persons; community services targeted to low- or moderate-income persons; activities that promote economic development by financing small businesses or farms; and activities that revitalize or stabilize low- or moderate-income geographies. 12 CFR 25.12(h), 228.12(h), 345.12(h), and 563e.12(g).

A lawful investment in a security issued by a nonprofit, like the lender, that uses the funds to promote community development by making loans to CDFIs that finance affordable housing for low- or moderate-income persons and promote economic development by financing small businessses, as you state the lender will do, is a qualified investment. To be considered in the bank's evaluation under the investment test, the invesment must benefit the bank's assessment area(s) or a broader statewide or regional area that includes the bank's assessment area(s). *See* 12 CFR 25.23(a), 228.23(a), 345.23(a), and 563e.23(a).

The lending test evaluates an institution's lending activities. Among the performance criteria considered in the lending test is an institution's community development lending, including the number and amount of community development loans and their complexity and innovativeness. *See* 12 CFR 25.22(b)(4), 228.22(b)(4), 345.22(b)(4), and 563e.22(b)(4). A "community development loan" is a loan that has "community development" as its primary purpose and, except in the case of a wholesale or limited purpose institution, benefits the institution's assessment area(s) or a broader statewide or regional area that includes the assessment area(s) and has not been considered as part of the institution's assessment as a home mortgage, small business, small farm, or consumer loan. 12 CFR 25.12(i), 228.12(i), 345.12(i), and 563e.12(h).

Under the lending test, community development loans originated by a third party in which an institution has invested will be considered, at the institution's option, subject to certain limitations. 12 CFR 25.22(d), 228.22(d), 345.22(d), and 563e.22(d). Generally, the agencies consider an institution to have "invested" in a third party within the meaning of this provision when the institution has made an equity or equity-like investment in the third party — not when the institution has made a loan to, or purchased an ordinary debt obligation of, the third party.

For example, an institution might purchase stock in a community development corporation (CDC) that lends in low- and moderate-income areas or to low- and moderate-income individuals in order to promote community development. The institution may claim a pro rata share of the CDC's loans as community development loans. By contrast, securities backed by loans, such as mortgage-backed securities, are not equity or equity-like investments in the third party that originated the loans. An institution that purchases these securities cannot receive consideration under the lending test for the loans underlying them, although the institution can receive consideration for the securities themselves under the investment test provided they meet the definition of qualified investment and are appropriately geographically targeted.

As noted above, no one can legally hold a true equity interest in a nonprofit like the lender. However, the purchase of the equity equivalents described above, while not a true equity investment, is sufficiently comparable to qualify as an investment within the meaning of the regulation. Like a true equity interest, the equity equivalents are fully subordinated to the claims of all debtors, are designed to raise revenue for the issuer, and have, in effect, an indeterminate term (because of the rolling tenor). The equity equivalents more closely

resemble preferred, rather than common, stock because they have a fixed rate of return and do not confer voting rights. *See* 11 William Meade Fletcher, Fletcher Cyclopedia of the Law of Private Corporations 5283 (1995). Based on this analysis, if the bank purchased these equity equivalents, examiners would consider in the bank's lending test evaluation, at the bank's request, the bank's pro rata share of any community development loans made by that benefit the bank's assessment area(s) or a broader statewide or regional area that includes its assessment area(s).

An investing institution's pro rata share of community development loans made by a *for-profit* third party is determined by the percentage of the capital of the third party contributed by the investing institution. The institution's pro rata share of community development loans by a *nonprofit* third party is determined in a comparable manner, taking into account the fact that nonprofit institutions do not have "capital" and are subject to different accounting rules than for-profit institutions.

The following example illustrates how a purchase of equity equivalents may be considered under the lending test: Assume a community development lender has $4 million in funds comparable to "capital" — $2 million from an investing institution's purchase of equity equivalents and $2 million from grants. Thus, the investing institution has supplied 50 percent of this $4 million. Assume further that the community development lender, after borrowing another $6 million, makes $10 million in community development loans during the period under review in the investing institution's CRA evaluation. Under the lending test, the investing institution may receive consideration for $5 million in community development loans, its pro rata share of the community development lender's community development loans, provided these loans benefit the investing institution's assessment area(s) or broader statewide or regional area that includes the assessment area(s).

To the extent an institution's investment is considered under the lending test, it will not also receive consideration under the investment test. 12 CFR 25.23(b), 228.25(b), 345.25(b), and 563e.25(b). In some circumstances an institution may receive consideration for part of an investment under the lending test and also receive consideration under the investment test for part of the investment that was not considered under the lending test. *See* OCC Interpretive Letter 673 (June 26, 1995) and the attached interagency interpretive letter.

I trust that this letter has been responsive to your inquiry. The financial supervisory agencies will consider incorporating this guidance into the formal written guidance on the new CRA regulation that is being developed by the staffs of the agencies.

Matthew Roberts
Director
Community and Consumer Law Division

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## 728 — July 1996

Cathy Donchatz, Director
Product Promotion Division
Department of the Treasury
Financial Management Service
Washington, D.C. 20227

Dear Ms. Donchatz:

This letter responds to your correspondence dated April 24, 1996, concerning the treatment under the revised Community Reinvestment Act (CRA) regulations of the Direct Deposit Too (DD Too) program that the Financial Management Service (FMS) hopes to develop. As you know, the four bank and thrift regulatory agencies have promulgated substantively identical CRA regulations.[1] Therefore, staffs from all of the agencies have considered the issues you raised, and they concur in the opinions expressed in this letter.

The purpose of the DD Too program is to expand direct deposit, especially to recipients of federal payments who do not presently have deposit accounts. FMS estimates that about 10 million people who receive federal salary and benefit payments lack deposit accounts. FMS also believes that some payment recipients that have deposit accounts but do not currently have their payments deposited electronically would be willing to accept direct deposit of their payments into a low-cost account.

The DD Too program would encourage financial institutions to offer an "easy to use" account principally for direct deposit of federal payments and debit transactions. Although FMS does not intend to establish uniform account criteria, it envisions that banks would offer accounts in which:

- checks would not be permitted to be drawn;

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[1] 12 CFR 25, 228, 345, and 563e (1996).

- only debit transactions would be permitted (except for the recurring direct deposit of federal payments);
- there would be no minimum balance requirement; and
- overdrafts would not be permitted.

You have asked whether a regulated financial institution that offers an account of this type (DD Too account) would receive favorable consideration under the CRA regulations. As explained more fully below, in some circumstances, a DD Too account could receive favorable consideration as a "community development service." Furthermore, the electronic deposit and debit features of DD Too could be considered as part of an alternative delivery system for the delivery of retail banking services through "electronic banking."

### Discussion

I. DD Too Concept

A. Community Development Service

The revised regulations provide different methods for evaluating a financial institution's CRA performance depending on the size of the institution and its business strategy. Under each of these methods, an institution may, under certain circumstances, receive favorable consideration for providing community development services that benefit its assessment area or a broader statewide or regional area that includes the assessment area. A large institution's CRA performance is typically evaluated under the lending, investment, and service tests. Examiners of large institutions consider community development services under the service test. 12 CFR 25.24, 228.24, 345.24, and 563e.24 (1996). Evaluation of a large institution's performance under the service test of the CRA regulations includes an assessment of the extent to which the institution has provided community development services and the innovativeness and responsiveness of the services. 12 CFR 25.24(e), 228.24(e), 345.24(e), and 563e.24(e) (1996). If the institution elects, a small institution's provision of community development services, including their innovativeness and responsiveness, are considered to determine whether the institution merits an "outstanding" rating. *See* 12 CFR 25 app. A(d)(2), pt. 228 app. A(d)(2), pt. 345 app. A(d)(2), and pt. 563e app. A(d)(2) (1996). The community development test, which is used to evaluate the record of an institution designated as a wholesale or limited purpose institution, also considers community development services. Evaluation of a wholesale or limited purpose institution's performance under the community development test includes an assessment of the innovativeness and responsiveness of the community development services. 12 CFR 25.25, 228.25, 345.25, and 563e.25 (1996). Finally, institutions evaluated on the basis of a strategic plan must include in their plan how they intend to meet the credit needs of their assessment area, particularly the needs of low- and moderate-income geographies and persons. They may meet credit needs through lending, investment, and/or services, as appropriate. 12 CFR 25.27, 228.27, 345.27, and 563e.27 (1996).

A "community development service" is a service that has "community development" as its primary purpose, relates to the provision of financial services, and has not been considered as part of an institution's provision of retail banking services. 12 CFR 25.12(j), 228.12(j), 345.12(j), and 563e.12(i) (1996). Community development means: affordable housing for low- or moderate-income persons; community services targeted to low- or moderate-income persons; activities that promote economic development by financing small businesses or farms; and activities that revitalize or stabilize low- or moderate-income geographies. 12 CFR 25.12(h), 228.12(h), 345.12(h), and 563e.12(g) (1996).

To qualify as a community development service, therefore, a deposit service must be targeted to low- or moderate-income persons. For example, a deposit service that reduces costs of, or otherwise improves access to, financial services for low- or moderate-income persons may be considered a community development service. Thus, the agencies have noted that community development services include offering "lifeline" accounts (low-cost or free accounts for basic banking needs). 59 Fed. Reg. 51232, 51239 n.3 (October 7, 1994).[2] Community development services also include low-cost or free government check cashing and similar services that have community development as the primary purpose. For example, as stated in the Supplementary Information to the revised regulations, "electronic benefit transfer and point-of-sale terminal systems that are designed to improve access, such as by decreasing costs, for low- or moderate-income individuals would receive favorable consideration." 60 Fed. Reg. 22156, 22160 (May 4, 1995).

Treatment of a DD Too account as a community development service depends on whether the account is

[2]The Supplementary Information to the October 7, 1994, proposed revision of the CRA rules stated that the provision of lifeline accounts would be considered a community development service. Although the Supplementary Information to the May 4, 1995, final revised rules did not include a similar reference to lifeline accounts as an example of a community development service, no substantive change was intended. Lifeline accounts are a community development service under the revised rules because they reduce costs of, and improve access to, financial services for low- or moderate-income persons

targeted to low- or moderate-income persons. For example, an account that is restricted to direct deposit of Supplemental Security Income payments would generally be targeted to low- or moderate-income persons. On the other hand, an account that is established to receive federal salary payments might not be targeted to low- or moderate-income persons. A DD Too account that is free or low-cost and that improves access for low- or moderate-income persons to financial services would be comparable to a lifeline account and therefore could qualify as a community development service.

B. Alternative Delivery System

Examiners also could consider a retail institution's provision of electronic banking services as an alternative system for delivering retail banking services. An alternative delivery system includes, for example, ATMs, banking by telephone or computer, loan production offices, and bank-at-work or bank-by-mail programs. 12 CFR 25.24(d)(3), 228.24(d)(3), 345.24(d)(3), and 563e.24(d)(3). An alternative delivery system would also include some components of DD Too, such as electronic deposit and electronic debit.

The consideration given to a financial institution's provision of an alternative delivery system depends on the availability and effectiveness of the system in serving low- or moderate-income areas and persons. 12 CFR 25.24, 228.24, 345.24, and 563e.24 (1996). A large institution's use of alternative delivery systems is evaluated under the service test. *Id.* If a small institution elects, its performance in providing delivery systems that enhance credit availability in its assessment area, including alternative delivery systems, is considered to determine whether the institution merits an "outstanding" rating. *See* 12 CFR 25 app. A(d)(2), pt. 228 app. A(d)(2), pt. 345 app. A(d)(2), and pt. 563e app. A(d)(2) (1996). Finally, institutions evaluated on the basis of a strategic plan might include use of alternative delivery systems in their plans. *See* 12 CFR 25.27, 228.27, 345.27, and 563e.27 (1996). Retail banking services, including alternative delivery systems, are not considered in the evaluation of wholesale or limited purpose institutions, which are evaluated under the community development test. *See* 12 CFR 25.25, 228.25, 345.25, and 563e.25 (1996).

III. Mandatory Electronic Fund Transfer

Your letter predates by one day the passage of a federal law that requires all federal payments to be made electronically. The Omnibus Appropriations Act of 1996[3] includes provisions that require all federal payments made after January 1, 1999, to be made electronically to a financial institution or another agent authorized by the recipient to receive the payments. The law authorizes the Secretary of the Treasury to prescribe regulations to ensure that federal payment recipients required to have an account at a financial institution to receive the electronic funds transfer will have access to an account at a "reasonable cost."

This law may affect the DD Too program and the CRA issues presented by your inquiry. Assuming that a financial institution is required to provide an account for the direct deposit of federal payments, as a general matter, that institution would be providing a community development service if the account is targeted to low- or moderate-income persons. However, the weight given to provision of a government-mandated account would depend on other factors in the CRA rules. For example, the effect on a large financial institution's CRA rating of this community development service would depend on the innovativeness and the responsiveness of the service to community needs. It appears unlikely, however, that examiners would consider the provision of a *government-mandated* account to be innovative or responsive to the particular needs of an institution's community.

Further, as a general matter, an institution that provides for the electronic deposit and debit of federal payments pursuant to the new law could be considered to be providing an alternative delivery system, which would be evaluated based on the availability and effectiveness of the system in delivering retail banking services in low- and moderate-income areas and to low- and moderate-income persons.

I trust that this letter has been responsive to your inquiry. The financial supervisory agencies will consider incorporating this guidance into the formal written guidance on the new CRA regulation that is being developed by the staffs of the agencies.

Matthew Roberts
Director
Community and Consumer Law Division

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[3]Pub. L. No. 104-134, 142 Cong. Rec. H3942 (daily ed. April 25, 1996) (to be codified at 31 U.S.C. 3332(f)(1))

## 729 — July 1996

Dear Sir/Madam:

This letter responds to your correspondence of May 28, 1996, which attempted to memorialize our May 8, 1996, telephone conversation. We had discussed how an institution should collect and/or report the location of small business and consumer loans, for Community Reinvestment Act (CRA) purposes, when the loans are made to borrowers with addresses consisting of post office boxes.

During our conversation, I understood that we were discussing the situation, which may occur in rural areas, in which small businesses or consumers have no street addresses and, thus, can provide their lenders with only rural route numbers and box numbers or post office box numbers. In such instances, institutions should geocode the locations* of these loans by town, state, and zip code. The location of the post office will serve as a proxy for the location of the small business or consumer.

In most cases, however, small businesses and consumers have street addresses in addition to post office box numbers or rural route and box numbers. Generally, institutions should ask their customer to provide, in the case of a small business or farm loan, the street address of the main business facility or farm or location where the loan proceeds otherwise will be applied and, in the case of a consumer loan, the street address of the residence of the borrower. *See* 12 CFR 25.12(p)(1) & (3), 228.12(p)(1) & (3), 345.12(p)(1) & (3), and 563e.12(o)(1) & (3).

Once the institution receives the information that the customer provides, it should collect, geocode and report the loan location based on the information that is provided by the customer. If a customer does not provide a street address, the institution may collect and report based on the information, e.g., the post office box or rural route and box number, that the customer provided.

As you know, the four bank and thrift supervisory agencies have promulgated substantively identical CRA regulations. Therefore, staff from all of the agencies have considered your issue, and they concur in the opinions expressed in this letter.

I hope this letter clarifies my advice. You may also be interested to know that the staffs of the four agencies are presently developing written guidance to assist in resolving interpretive questions arising under the new CRA regulations.

Matthew Roberts
Director
Community and Consumer Law Division

* * *

## 730 — July 1996

Dear Sir/Madam:

I am writing in response to your April 17, 1996 letter to the Office of the Comptroller of the Currency (OCC) on behalf of the bank in which you seek our concurrence that loans proposed by the bank to an unaffiliated distributor of mutual funds would not be subject to the interaffiliate lending restrictions contained in 12 USC 371c. Based on the information and representations set forth in your letter, the OCC concurs with your conclusion that the loan transactions you describe will not be subject to section 371c.

### Proposed Transactions

The bank, a wholly-owned subsidiary of the corporation, currently controls a broker-dealer subsidiary, the brokerage and a general partnership that is the investment adviser for the bank's existing mutual fund clients. The bank is now considering the acquisition of a second mutual fund investment adviser that is not presently affiliated with a bank (the "adviser"). If acquired, the adviser would either be held as a separate, wholly-owned subsidiary of the bank or be combined with the other subsidiary. The mutual funds advised by the adviser (the "investment companies") would retain an independent distributor that is not affiliated with the bank to provide distribution services (the "distributor"). The distributor would enter into arrangements with various broker-dealers (the "selling brokers") to sell as agent for their customers shares of the investment companies under the "back-end load"/Class B shares structure. One of the selling brokers would be the brokerage.[1]

*Institutions that are required to collect and, for some types of loans, report loan information must collect and report the "loan location." "Loan location" is defined in 12 CFR 25.12(p), 228.12(p), 345.12(p) & 563e.12(o). A loan is located in a "geography," which means "a census tract or block numbering area delineated by the United States Bureau of the Census in the most recent decennial census." 12 CFR 25.12(l), 228.12(l), 345.12(l), & 563e.12(k). Institutions subject to the data collection and reporting provisions, therefore, must geocode loan locations by census tract or block numbering area.

[1] [ ] would not enter into such arrangements.

The investment companies principally use a "back-end load structure" to sell shares (which are typically referred to as "Class B" shares). Under this structure, the distributor pays to the selling broker a commission at the time of sale of 3 or 4 percent of the current net asset value of the shares being purchased ("retail commission"). There is no sales charge imposed on the investor at the time of purchase. There is, however, a sales charge imposed on the investor at the time the shares are redeemed. This charge is called a "contingent deferred sales charge" or "CDSC" and is payable by the investor to the selling broker, which is obligated to repay it to the distributor.

The mutual funds using this "back-end load structure" and offering Class B shares have adopted "distribution plans" under Rule 12b-1 of the Investment Company Act of 1940. Pursuant to these distribution plans, the mutual funds compensate the distributor for its services, including the payment of the retail commission, through the payment of an ongoing annual distribution fee (i.e., a 12b-1 fee). The annual distribution or 12b-1 fee paid by the mutual fund to the distributor may be as much as .75 percent of the net asset value of the mutual fund's Class B shares. In essence, the distributor advances the retail commission to the selling broker in anticipation of being compensated over time for that advance through a combination of the CDSCs and the annual 12b-1 fees.

To finance the retail commissions, the bank proposes to make loans (the "loans") either to the distributor or to a wholly-owned subsidiary of the distributor which provides distribution services only for mutual funds advised by the adviser. The proceeds from the loans would be used to pay retail commissions and other expenses of the distributor. The loans would be on market terms. As security for the loans, the distributor would pledge its rights under its distribution contract with the investment companies to receive future distribution fees and its right to receive CDSCs. The 12b-1 fees and the CDSCs would be expected to provide the funds to repay the interest and principal on such loans. The bank may also receive, in addition to the stated interest on the loans and the return of principal, an amount up to the amount by which the 12b-1 fees and CDSCs received exceed the distributor's payments of interest and principal and the distributor's service charges.

## Legal Analysis

You have asked whether the loans would be subject to the interaffiliate transaction restrictions contained in 12 USC 371c. Section 371c imposes quantitative and qualitative restrictions on a bank's "covered transactions" with any "affiliate." The term "covered transactions" includes, among other things, loans or extensions of credit to affiliates. The statute further provides that a transaction by a member bank with any person shall be deemed a transaction with an affiliate "to the extent that the proceeds . . . are used for the benefit, or transferred to, that affiliate."[2] Thus, an analysis of the interaffiliate lending restrictions begins with the issue of whether the loans made by the bank to the distributor are deemed, either directly or by attribution under section 371c(a)(2) to constitute a "covered transaction" with an "affiliate."

The term "affiliate" is defined, for purposes of section 371c, as a company that controls the member bank or a subsidiary of that controlling company, a bank subsidiary of a member bank, a company that is controlled for the benefit of the shareholders of the member bank, a company with an interlocking majority of directors with the member bank, or any investment company which the member bank or its affiliate advises.[3] The loan to the distributor is not subject to section 371c because the distributor is not an affiliate of the bank. Neither the bank nor the corporation (collectively with the bank) owns any shares of the distributor, and the distributor does not otherwise fall within the definition of "affiliate." Thus, no direct "affiliate" relationship exists between the bank and the distributor.

Upon receipt, the distributor uses the proceeds to pay retail commissions to the selling brokers. As noted above, section 371c(a)(2) requires a loan to a third party, such as the distributor, to be attributed to any affiliate that receives the loan proceeds or the benefit of those proceeds. In this case, however, none of the selling brokers is an "affiliate" of the bank. All but one of the selling brokers have no relationship with the bank. The bank does not own any of their stock, and they do not otherwise fall within the definition of "affiliate." One selling broker, the brokerage, is a subsidiary of the bank. Section 371c(b)(2)(A), however, specifically excludes from the definition of affiliate "any company, other than a bank, that is a subsidiary of a member bank. . . ." Accordingly, even though the brokerage will receive the proceeds of the bank's loan to the distributor, section 371c does not apply to restrict the transaction.[4]

The final issue is whether the loans are attributable to the investment companies under section 371c(a)(2). Section 371c(b) defines as "affiliates" investment companies for which a bank or any of its *affiliates* acts as

[2] 12 USC 371c(a)(2).
[3] 12 USC 371c(b)(1).
[4] Similarly, even if the advisor were to receive any benefit of the loan proceeds, as a nonbank subsidiary of a member bank, the advisor also is excluded from the definition of "affiliate."

investment adviser. Thus, the plain language of the statute does not include within the definition of "affiliate" an investment company advised by a *subsidiary* of a member bank.[5]

Moreover, even if the investment companies were regarded as "affiliates" of the bank, no loan proceeds will be used for the benefit of the investment companies in any direct or tangible manner. While the success of the distributor and selling brokers results in increased sales of shares of the investment companies and thus growth in the size of the investment companies, it is unclear how this is a benefit to the investment companies themselves. Even if a form of benefit exists, it is intangible and impossible to quantify, and therefore not the type of benefit contemplated by the statute. Accordingly, the making of the loan does not result in a "covered transaction" with an "affiliate" with respect to the investment companies.[6]

### Conclusion

Because the bank's loan to the distributor does not constitute a covered transaction with an affiliate of the bank, I conclude that none of the transactions described above are subject to 12 USC 371c. The opinion expressed herein, however, relates solely to applicability of 12 USC 371c to the bank and the transactions described in your letter. I express no opinion as to the role of the holding company or the brokerage and any associated legal or supervisory issues, or on federal securities law requirements that may apply to the proposed arrangement. Any change in the structure of the transactions you describe may require a different conclusion.

Julie L. Williams
Chief Counsel

* * *

[5] *See* 12 USC 371c(b)(1)(D)(ii)

[6] This reading of the statute is consistent with the attribution rules contained in Regulation O and the National Bank Act's lending limits. The attribution rule in Regulation O refers to "tangible economic benefit." 12 USC 215.3(f). The attribution rule applicable to the lending limit restrictions contained in 12 USC 84 requires a "direct economic benefit." 12 CFR 32.5(b). Although section 371c does not, by its terms, require the "benefit" to an affiliate to be "direct," "tangible," or even "economic," the OCC historically has construed section 371c(a)(2) in a manner that is consistent with the attribution rules in Regulation O and the OCC's lending limit rules.

## 731 — July 1996

Re: Authority of [*Bank*] to Bid on The E-Z Pass System and to Perform the Contract by Means of an Operating Subsidiary

Dear Sir/Madam:

This responds to your letter, dated May 31, 1996, requesting confirmation of telephone conversations you had with attorneys on my staff regarding the referenced issue. Specifically, you discussed whether the bank would be authorized to enter into a contract with a public authority to operate on behalf of the public authority an electronic toll collection ("ETC" or "E-Z Pass") system. At this time, the bank has been prequalified as one of the bidders to obtain this contract. After the submission of the bid on July 15, 1996, but prior to executing a contract, the bank intends to file an operating subsidiary notification with the OCC. Because the bank is obligated to proceed with the contract, in the event the bank is the winning bidder, you requested confirmation in writing that the proposal is legally permissible for the bank and the operating subsidiary.

### The Proposal

The bank would enter into a contract with a public authority that is acting on behalf of itself and other public authorities (the "consortium," who are also members of the E-Z Pass Interagency Group) to implement the ETC system throughout the roadways and facilities operated by the consortium. The bank would not be involved in financing the project, which is to be funded by the consortium, nor would the bank own the facilities and equipment. The ETC system would allow toll road patrons to use a transponder tag attached to the vehicles to be scanned by reader equipment for patron account identification while the vehicles pass through reader-equipped toll lanes. The contract specifies the transponder and reader equipment manufacturer but the bidder is required to design, furnish and install the ETC equipment at modified toll plazas. The winning bidder is also required to design, implement and operate a customer service center (CSC) to manage toll road patron E-Z Pass accounts for all consortium members. The ETC system is intended to interact with the ETC systems of the E-Z Pass Interagency Group, including the road agencies of other states in the region, so as to introduce and standardize ETC in the region. The E-Z Pass system permits identification of toll road patron vehicles and the automatic debiting of the prepaid balance in their E-Z Pass accounts by means of information transmitted to and received from the CSC.

The toll road patrons' E-Z Pass accounts are maintained by the bank as agent for, and on behalf of, the consortium. The winning bidder is required to provide the CSC computer system as a complete operational system with all necessary hardware and software components required for operation. As winning bidder, the bank would be expected to operate the CSC for an initial period of seven years.

The CSC must consist of a processing center and an adequate number of walk-in facilities to administer the E-Z Pass accounts (e.g., inquiries, new enrollments, payments, account statements), interface with consortium and non-consortium members' ETC systems (e.g., ETC toll transactions and exception and audit information), provide marketing services (e.g., deposits, return items, investments, reconciliations), and provide violation enforcement imaging processing. The CSC will handle customers by attended telephone, automated voice/response, mail, facsimile, and in person. In addition to operating the separate processing center, the bank intends to use its branches for walk-in facilities to provide information about the system, distribute E-Z Pass account applications, enroll customers and issue tags, accept payments, issue tag replacements, provide account balances and status information, and resolve disputed items. In the performance of these activities, particularly accepting payments for the E-Z Pass accounts, the bank is acting as agent for the consortium and not as principal. E-Z Pass accounts are not bank deposit accounts for the toll patrons, but instead represent a record of prepaid tolls collected and held by the bank on behalf of the consortium. Under the terms of the E-Z Pass system, the toll patron's prepaid balance is reduced or debited each time the patron passes through a reader equipped toll plaza. Toll road patrons will periodically replenish their prepaid balances for their E-Z Pass accounts. The collected funds are deposited in or transmitted to a bank account for the consortium.

In addition to the requirement to design, arrange for construction of and operate the CSC, the winning bidder is required to perform toll plaza infrastructure and toll lane traffic flow modifications in order to implement the E-Z Pass system and to integrate the ETC data into existing toll audit systems. This will require furnishing and installing the ETC equipment and computers, toll plaza and advance signing, plaza/ramp striping plans, operational plans for plaza and ramp operation and disaster/equipment failure contingency plans, and providing a communications system. Finally, the bank may also propose as part of its bid the technology to issue and use Smart Cards as an optional identification device for toll road patrons that would operate as a substitute for the transponder tags and trigger a debit of the patron's prepaid balance in the E-Z Pass account.

Should it be the winning bidder, the bank proposes to assign the contract to, if permitted by the consortium, or have the contract performed under subcontract by, a wholly-owned operating subsidiary of the bank. Required design, construction and equipment installation would be performed by recognized and qualified subcontractors who would indemnify the bank and the subsidiary to the maximum extent for any claims attributable to the work of each of the subcontractors. In addition, the bank and the subsidiary will maintain general liability insurance as appropriate under the circumstances. The primary value to the bank in bidding on the contract is the operation of the CSC for the initial seven-year period which would be conducted by the bank and/or the subsidiary and the possibility of issuing and utilizing Smart Card technology.

## Legal Analysis

### *Permissibility*

The National Bank Act, in relevant part, provides that national banks shall have the power:

> [t]o exercise ... all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes ...

12 USC 24(Seventh).

The Supreme Court has held that the powers clause of 12 USC 24(Seventh) is a broad grant of power to engage in the business of banking, including but not limited to the enumerated powers and the business of banking as a whole. *See NationsBank of North Carolina, N.A. v. Variable Life Annuity Co.,* 115 S.Ct. 810 (1995) (*VALIC*). Judicial cases reflect three general principles used to determine whether an activity is withing the scope of the "business of banking": (1) is the activity functionally equivalent to or a logical outgrowth of a recognized banking activity; (2) would the activity respond to customer needs or otherwise benefit the bank or its customers; and (3) does the activity involve risks similar in nature to those already assumed by banks. *See*, e.g., *Merchants' Bank v. State Bank*, 77 U.S. 604, 648 (1871) (certification of checks has grown out of the business needs of the country and involves no greater risk than a bank giving a certificate of deposit); *M&M Leasing Corp. v. Seattle First Nat. Bank*, 563 F.2d 1377, 1382-83 (9th Cir. 1977), *cert. denied*, 436 U.S. 987 (1978) (personal property lease financing is "functionally interchangeable" with the express

power to loan money on personal property); *American Insurance Association v. Clarke,* 865 F.2d 278, 282 (D.C. Cir. 1988) (standby credits to insure municipal bonds is "functionally equivalent" to the issuance of a standby letter of credit). Further, as established by the Supreme Court in *VALIC*, national banks are authorized to engage in an activity if it is incidental to the performance of the five enumerated powers in section 24(Seventh) *or* if it is incidental to the performance of an activity that is part of the business of banking.

It is well established that a national bank or its operating subsidiary[1] may provide data processing to perform services expressly or incidentally authorized to national banks. *See* OCC Interpretive Letter No. 677 (June 28, 1995) *reprinted in* [1994-1995 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83.625. Moreover, the recent revision and renumbering of the OCC Interpretive Ruling stating this authority, 12 CFR 7.3500 (1995), recognizes the rapid advancement of technology and authorizes a national bank to "perform, provide, or deliver through electronic means and facilities any activity, function, product, or service that it is otherwise authorized to perform, provide or deliver." *See* the new regulation at 12 CFR 7.1019 (1996).

The collection and processing activities that the bank proposes to perform for the consortium are clearly part of the business of banking. The Supreme Court has established that 12 USC 24(Seventh) permits a national bank to "do those acts and occupy those relations which are usual or necessary in making collections of commercial paper and other evidences of debt" for its customers. *Miller v. King,* 223 U.S. 505, 510 (1912) (finding that a national bank may collect a judgment for its customer, and may also sue the bank's attorney in order to recover misused proceeds of the judgment). The activities associated with the operation of the CSC and the activities conducted at the walk-in facilities (including toll road patron tag issuance and E-Z Pass account initiation, processing payments and account management on behalf of the consortium, and the possible issuance of the alternate identification and debit system by means of a Smart Card) essentially are financial management services for a customer (the consortium) involving collection and remittance of funds. In effect, the bank/subsidiary in operating the CSC is acting as agent for the consortium in collecting prepaid tolls from the toll road patrons who obtain the tags and set up E-Z Pass accounts.

Moreover, the described activities are similar to those upheld in *Corbett v. Devon*, 12 Ill. App.3d 559, 299 N.E.2d 521 (App. Ct. 1st Cir. 1973), where the court found that national banks' participation in Illinois' program for motor vehicle license validation and renewal and the distribution of license plates, remitting fees to the state, was not ultra vires. The court stated that banks "are assisting in the performance of a public service, a large part of which is intimately connected with the ordinary and traditional banking function of collecting and remitting funds for other parties." *Corbett*, 299 N.E.2d at 529.

Similarly, the bank's or subsidiary's operation of the CSC and the use of the bank's branches as walk-in facilities to conduct the ETC system activities are part of its banking business and, therefore, legally permissible. Under any of the three general standards for determining the scope of the business of banking, collection and remittance activities are permitted to be performed, provided and delivered through electronic means and facilities by the new regulation. First, these activities are clearly functionally equivalent to or a logical outgrowth of recognized banking functions, as acknowledged by the judicial precedent. *See Miller v. King* and *Corbett v. Devon supra*. Second, the bank's performance of these activities will benefit the bank and its customers, both the consortium and the toll road patrons who can use the bank's many branches to enroll in and use the E-Z Pass system. The bank will benefit from a new source of revenue for operating the CSC and may develop new customer relationships among enrolled E-Z Pass users for its own banking products and services. Finally, the risks to the bank in operating the CSC are the same risks associated with permissible collection and remittance operations the bank performs for other customers, e.g., lockbox operations in which the bank collects funds for crediting to the customers' accounts. Accordingly, these activities are within the scope of the business of banking, may be performed by electronic means and facilities, and, thus, are legally permissible.

Incidental to these permissible banking activities is the ability to arrange for, by means of subcontracting, the one-time design, construction, and installation of facilities and equipment necessary to conduct the activities. As part of the bid package required by the consortium, and in order to obtain the contract to operate the ETC system at least for seven years, the bank is required to arrange for the one-time design, construction and installation of the facilities and equipment necessary to render the ETC system operational. Consequently, the ability of the bank to arrange for others to perform the nonbanking activities is integral to the bid process to obtain the contract for operation of the banking-related activities. At no time will the bank perform these engineering and construction activities; instead, the bank will arrange for the performance of these activities by

[1] Such activities that are part of or incidental to the business of banking may also be carried out by means of an operating subsidiary 12 CFR 5.34(c)

- The articles of incorporation of the company will be restated to limit its activities to those permissible for national banks.

- If the bank decides at any time that the company is engaging in activities impermissible for national banks, it may demand redemption of the series B common stock.

- As holder of series B common, the bank will be entitled to vote by series on (and effectively veto) changes in, among other things, the rights or number of series B common or series A preferred and series B preferred, the creation of new classes or series of shares having preferences superior or equal to those of series B common or series A preferred and series B preferred shares, and any change in the provision of the articles of incorporation according such voting rights.

## Analysis

The bank's plan to purchase a 5.5 percent interest in the company initially raises the issue of the authority of a national bank to hold a minority interest in a corporation. A recent OCC interpretive letter extensively analyzed the authority of national banks under 12 USC 24(Seventh) to own stock, and reviewed OCC precedents on the ownership of stock in amounts less than that required for an operating subsidiary, i.e., noncontrolling stock investments. Interpretive Letter No. 697, [Current] Fed. Banking L. Rep. (CCH) ¶ 81-013 (Nov. 15, 1995). That letter concluded that ownership of a noncontrolling interest in a corporation is permissible provided that four standards, drawn from OCC precedents, are satisfied. They are:

1) The activities of the enterprise in which the investment is made must be limited to activities that are part of, or incidental to, the business of banking;

2) The bank must be able to prevent the enterprise from engaging in activities that do not meet the foregoing standard, or be able to withdraw its investment;

3) The bank's loss exposure must be limited, as a legal and accounting matter, and the bank must not have open-ended liability for the obligations of the enterprise; and

4) The investment must be convenient or useful to the bank in carrying out its business and not a mere passive investment unrelated to *that bank's* banking business.

Each of these factors is discussed below and applied to your proposal.

*1. The activities of the enterprise in which the investment is made must be limited to activities that are part of, or incidental to, the business of banking.*

Our precedents on minority stock ownership have recognized that the enterprise in which the bank takes an equity interest must confine its activities to those that are part of or incidental to the conduct of the banking business. *See, e.g.,* Interpretive Letter No. 380, [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,604 n.8 (Dec. 29, 1986) (since a national bank can provide options clearing services to customers, it can purchase stock in a corporation providing options clearing services); Letter from Robert B. Serino, Deputy Chief Counsel (Nov. 9, 1992) (since the operation of an ATM network is "a fundamental part of the basic business of banking," an equity investment in a corporation operating such a network is permissible).

You have represented that the company's activities will involve the design and development of a network for electronic transfers of funds and financial information, along with the development and marketing of related software. The OCC previously has approved the activities the company will perform.

OCC Interpretive Ruling 7.1019, Furnishing of products and services by electronic means and facilities, 61 Fed. Reg. 4849, 4865 (1996) (to be codified at 12 CFR 7.1019), permits national banks to provide permissible services by electronic means. The OCC has permitted a national bank to participate in a communications link between subscribers and their banks as well as permitted subscribers to communicate with each other. Interpretive Letter No. 346, [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,516 (July 31, 1985). The OCC also has approved electronic data interchange services for financial information, Interpretive Letter No. 653, [1994-1995 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,601 (Dec. 22, 1994) (informational and payments interface). National banks may use automated data processing to provide billing services and accounts receivable services for itself and others, Interpretive Letter No. 419, [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,643 (Feb. 16, 1988), and engage in data processing related to funds transfer and cash management, *id.* (funds transfer); Letter from Peter Liebesman, Assistant Director, Legal Advisory Services Division (Dec. 13, 1985) (cash management); Interpretive Letter No. 611, [1992-1993 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,449 (Nov. 23, 1992) (cash management, funds transfer).

Thus, the activities to be performed by the company are activities that are part of or incidental to the business of banking, and the first standard is satisfied.

*2. The bank must be able to prevent the enterprise from engaging in activities that do not meet the foregoing standard, or be able to withdraw its investment.*

The activities of an enterprise in which a national bank invests must be part of or incidental to the business of banking not only at the time the bank initially purchases stock, but they must remain so for as long as the bank has an ownership interest. However, minority shareholders in a corporation do not possess a veto power over corporate activities as a matter of corporate law. One way to assure continuing compliance with the first standard is for the corporation's articles of incorporation or bylaws to limit its activities to those that are permissible for national banks. *See, e.g.,* Letters from Peter Liebesman, Assistant Director, Legal Advisory Services Division (January 26, 1981 and January 4, 1983).

You have stated that the company's articles of incorporation will be amended to limit its activities to those permissible to national banks. Also, several other provisions, described in the "Background" section above, provide additional avenues for the bank to ensure that while it has an investment in the company, the company's activities will remain permissible. These provisions assure that the company will not engage in any activity that is not permissible for a corporation having a national bank shareholder. The bank effectively will be able to prevent the company from engaging in any impermissible activity as long as it continues to own shares in the company. Thus, the second standard is satisfied.

*3. The bank's loss exposure must be limited, as a legal and accounting matter, and the bank must not have open-ended liability for the obligations of the enterprise.*

A primary concern of the OCC is that national banks should not be subjected to undue risk. Where an investing bank will not control the operations of the entity in which the bank holds an interest, it is important that a national bank's investment not expose it to unlimited liability. Normally, this is not a concern when a national bank invests in a corporation, for shareholders are protected by the "corporate veil" from liability for the debts of the corporation. 1 William M. Fletcher, Fletcher Cyclopedia of the Law of Private Corporations 25 (perm. ed. rev. vol. 1990). In the present case, both the company and the bank will be separate corporations, with their own capital, directors, and officers.

Further, the bank has advised that the appropriate treatment for its investment in the company will be the cost method of accounting. Under this method, which is used for equity interests of less than 20 percent in corporations, losses recognized by the investor will not exceed the amount of the investment (including extensions of credit or guarantees, if any) shown on the investor's books. *See generally,* Accounting Principles Board, Op. 18, 19 (1971).

Therefore, for both legal and accounting purposes, the bank's potential loss exposure should be limited to the amount of its investment. Since that exposure will be quantifiable and controllable, the third standard is satisfied.

*4. The investment must be convenient or useful to the bank in carrying out its business and not a mere passive investment unrelated to that bank's banking business.*

Twelve USC 24(Seventh) gives national banks incidental powers that are "necessary" to carry on the business of banking. "Necessary" has been judicially construed to mean "convenient or useful." *Arnold Tours, Inc. v. Camp,* 472 F.2d 427, 432 (1st Cir. 1972). The provision in section 24(Seventh) relating to the purchase of stock, derived from section 16 of the Glass-Steagall Act, was intended only to make it clear that section 16 did not authorize speculative investments in stock. Interpretive Letter No. 697, *supra.* Therefore, a consistent thread running through our precedents concerning minority stock ownership is that such ownership must be convenient or useful to the investing bank in conducting its banking business. The investment must benefit or facilitate that business, and cannot be a mere passive or speculative investment. *See, e.g.,* Interpretive Letter No. 543, [1990-1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,255 (Feb. 13, 1991); Interpretive Letter No. 427, [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,651 (May 9, 1988); Interpretive Letter No. 421, [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,645 (Mar. 14, 1988).

As set forth in the "Background" section, the bank and the company already have a contractual relationship relating to the company's business which is limited to two years unless the bank becomes and remains sole owner of the series B common stock. Thus, the proposed investment will facilitate the bank's continued participation in the network. As discussed, the bank is using participation in the network as a means to offer its customers and correspondent banks a range of electronic banking services that the bank could not as economically offer directly. It is clear that the company's services will provide the bank and other banks involved in the network with the opportunity to offer electronic data interchange without establishing separate systems and maintaining them themselves. Thus, the in-